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IMPACT OF TREASURY DEPARTMENT'S TAX REFORM PROPOSAL ON OIL AND GAS INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON THE

IMPACT OF TREASURY DEPARTMENT'S TAX
REFORM PROPOSAL ON OIL AND GAS INDUSTRY

OKLAHOMA CITY, OK, FEBRUARY 15, 1985

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IMPACT OF TREASURY DEPARTMENT'S TAX REFORM PROPOSAL ON OIL AND GAS INDUSTRY

FRIDAY, FEBRUARY 15, 1985

U.S. Senate,
Committee on Energy and Natural Resources,
Oklahoma City, OK.

The committee met, pursuant to notice, at 10 a.m., in the House Chambers, State Capitol Building, 2300 North Lincoln Boulevard, Oklahoma City, OK, Hon. Don Nickles, presiding.

Present: Senator Nickles.

Also present: E. David Doane, senior counsel; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator Nickles. We will begin the hearing.

I want to thank all of our visitors and also all of our panelists. I think the fact that this many have shown up on a Friday morning shows the interest on this issue.

This is a formal Senate Energy and Natural Resources Committee hearing, on the Treasury Department's tax proposal.

We will be hearing and considering testimony from a lot of experts in the energy area, primarily from Oklahoma, but also representing industries and activities throughout the United States.

I want to thank the Energy Committee, particularly David Doane and Betsy Moler for their assistance in setting up this hearing, and I want to thank especially all of our panelists and guests for their participation in the hearing as well.

I think it is important when we have an issue of this significance and this magnitude, that we hear from Oklahomans, we hear from the field, and we get some input from people who are directly affected.

Too many times when we have a proposal such as this, we only hear from the paid professional lobbyists in Washington, DC, and sometimes we don't get the real meaning of its impact and what it would mean in the real world. So that is the purpose of this hearing.

The proposal, as many of you are well aware, is just a proposal. I am pleased that it is only a proposal. It is not even in bill form yet. It is our desire and my intention to do everything that we can possibly do to see that it doesn't become a bill, and that it is not the administration's proposal when they submit it to Congress.

We are trying to get some ideas of the impact that this legislation would have on the energy industry so we can convince the Treasury Department, and those who will be making the decisions all the way up to the President of the United States, that this particular proposal is shortsighted, would actually do more damage than good, and should be changed before it is submitted to Congress.

If it is not changed before it is submitted to Congress, it is my intention to do everything that we can possibly do to make sure that it is changed before it goes through the Senate or before it becomes law.

It is also my expectation and my belief that it will be changed. Should it be submitted in its present form, I expect that it will be changed before it gets through the Senate.

There are several steps before any proposal becomes a law. The first step is that it has to be written in bill form. The Treasury plan has not been introduced in bill form.

Then it is sent to Congress. And then Congress, through the committees and also through efforts on the Senate floor, usually amends or rewrites those proposals.

Certainly, that is the case with tax legislation. Whatever proposal is sent up will be modified, probably substantially, both in the Finance Committee and on the floor of the Senate.

I will work with Senator Boren and other members of the Oklahoma delegation to do everything that we possibly can to modify the provisions as they currently stand so they won't be so detrimental to Oklahoma and to our country.

I think that is really important. I think a lot of people have not recognized the detrimental impact that this proposal could have on our country; not only on the energy industry, but the entire Nation.

It will affect our national energy policy. A couple of years ago we had active drilling rigs numbering over 4,500. Today I think we have 2,100 or maybe 2,200. So, the number of active rigs has declined considerably.

Should this proposal become law, you would find that the number of active rigs would decline substantially further. Many estimates are around 30 percent further.

If we have a lot less drilling activity in this country, that means that our dependence on foreign sources would increase. Today we are importing something to the tune of 5 million barrels per day. That costs us in dollars exported, negative balance of trade today, $55 to $65 billion per year.

If you think of that, that is right at half of the negative balance of trade that we have in this country right now. Certainly, that is a mass exodus of dollars.

If this proposal should be passed in its present form, that would only increase, and you would find instead of paying $55 billion a year for imported oil and products, that figure could increase substantially. Of course, that has a detrimental impact on all of our country, and certainly on the energy industry as well.

So, there are a lot of things that need to be considered and I hope that we will bring them out at today's meeting.

I met with Treasury Secretary Regan when he was Treasury Secretary. We did have several Oklahomans that made that trip as well, and we presented our views to him.

I also met with Jim Baker, who is now Treasury Secretary, on a couple of occasions on this proposal.

I will also tell you that it is my intention and my expectation that I will be meeting with the President of the United States within the near future on this proposal as well. I will be going to the President trying to assure him and let him know how detrimental this proposal is and urge him to change it before it is submitted to Congress.

It is my hope and expectation that it will be changed before it is submitted to Congress. I hope by getting the President's ear that we will be successful.

We have several distinguished panelists. Again, I appreciate their willingness to join us here this morning.

I also have a statement from the chairman of the Senate Energy and Natural Resources Committee, Senator McClure, which we will enter into the record.

[The prepared statement of Senator McClure follows:]

STATEMENT OF HON. JAMES A. MCCLURE, A U.S. SENATOR FROM THE STATE OF IDAHO

The Treasury Department, in its tax reform proposals, has recommended a number of changes that would profoundly affect the oil and industry. particularly, the repeal of percentage depletion for oil and gas, and repeal of the option to expense intangible drilling costs. The industry has responded by claiming that enactment of the tax reform plan would virtually eliminate outside investment in drilling operations, resulting in a devastating impact on independent producers and a serious reduction in domestic exploration and development activity.

I am deeply concerned about these possible consequences because it is essential that we maintain the financial health of our oil and gas industry. One reason is that our current levels of domestic production compel us to import large volumes of oil. During 1984, our imports of crude oil and petroleum products averaged over five million barrels per day. This volume was about 32 percent of total demand last year, and it amounts to more than a nine percent increase over 1983 import levels. Imports for 1985 are projected by the industry to increase further by four percent over last year's level. From a national viewpoint, we simply cannot afford to increase our dependence on foreign supplies of oil.

The purpose of this hearing is to obtain detailed information on what would occur if the Treasury Department's proposals were enacted. It is most important, at this early stage of the debate, to begin to look carefully at how individual companies would be affected. We can then make an assessment of the broader, long-term consequences.

The Treasury Department's tax reform plan is nothing more than a proposal. President Reagan has not endorsed it. This hearing will contribute to the building of a record to be used in convincing the President that the proposed tax reforms for the oil and gas industry should not be adopted. I am pleased to note that Senator Nickles has assumed a major leadership role in working toward that objective.

I wish to express my appreciation to Senator Nickles for presiding at today's hearing. I will continue to support his efforts to ensure that the President and the Members of Congress are fully aware of the adverse impacts of the Treasury plan on the oil and gas industry.

Senator NICKLES. We will have several witnesses, about 19 witnesses, I believe.

Our first panelist this morning will be Danny Boggs. Danny Boggs is Deputy Secretary of Energy for the Department of Energy, from Washington, DC.

Mr. Boggs, we appreciate your willingness to join us today. I look forward to your presenting your views.

STATEMENT OF HON. DANNY J. BOGGS, DEPUTY SECRETARY OF ENERGY, DEPARTMENT OF ENERGY

Mr. BOGGS. Thank you, Mr. Chairman.

It is a pleasure to be here before the Senate Committee on Energy and Natural Resources. It is a particular pleasure to appear here before you, Senator, because you have always been a strong voice for America's energy security and for a growing American economy.

As you indicated, there is not an administration tax proposal; there is a Treasury report. However, in the state of the Union address, the President clearly set forth a number of principles on which he insists that the final proposal would be based.

These include that tax reform will not be a tax increase in disguise; that personal tax rates be made as low as possible. Of particular interest, I believe, to members of this committee, the President said, "We will propose reducing corporate rates while maintaining incentives for capital formation."

This commitment to economic growth underlies the administration's tax reform initiative. The Department of Energy is currently reviewing the Treasury Department proposal to ensure that any tax simplification legislation does not threaten the essential health of the energy sectors of our economy, especially in view of the capital-intensive nature of those industries and their importance for national security.

Our analysis suggests that the current version of the proposal, by increasing the effective tax rate for exploration and production companies, especially independents, would reduce future domestic production of oil and natural gas.

Given the strategic importance of oil and natural gas to our economy and the important contribution by independents to our domestic supply of those fuels, any changes in energy taxation must be undertaken with great care.

The Department views with great concern some provisions of the current version of the Treasury tax proposal, which we believe need to be revised in order to maintain incentives for capital formation.

An adequate domestic supply of oil and natural gas is vital to the national security and economic well-being of the United States.

It is true that we are currently experiencing a worldwide surplus of oil and natural gas productive capacity. Energy consumers are benefiting from that surplus, as they should. But it would be extremely shortsighted to use the current surplus as a justification for accepting thoughtlessly a reduction in exploration and production of domestic oil and gas supplies.

A significant decline in U.S. oil and gas production would increase our vulnerability to oil supply disruptions and artificially high prices.

We believe that if the Nation is to maintain that adequate supply of oil and gas, it is imperative that our industry receive an adequate after-tax return to compensate for the increasing costs of exploration and development.

The Treasury tax proposal has many components. Looking first at its effect on future discoveries, the economic value of most future oil and natural gas prospects will fall under the Treasury tax proposal.

The primary concern for all oil and gas producers will be the elimination of intangible drilling cost expensing. The loss of the immediate expensing of dry-hole costs will also be damaging.

The Treasury proposal eliminates the percentage depletion allowance for independents, but continues to allow cost depletion. However, since percentage depletion will normally allow the recovery over time of a larger amount, using cost depletion alone will reduce the amount of deductions that independents can claim.

Two other provisions of the proposal will also increase the tax burden on future prospects. These are the repeal of the accelerated cost recovery system, which means that those expenses that are spread out over time have to be spread out over a longer period; and, also, the repeal of the investment tax credits.

A complete picture does require us to note that some provisions of the proposal would benefit producers when compared with current tax laws. They would benefit most from the reduction in the corporate tax rate from 46 percent to 33 percent, if that provision is retained.

The windfall profits tax repeal would provide a little bit of help, although, in fact, it is likely that the only category of oil significantly affected by the phaseout would be tier 1 oil, most of which is owned by majors.

In summary, higher initial tax payments will reduce the net expected value of future prospects and will result in lower future domestic reserve additions and production.

The effect of the proposal on existing production is somewhat more complicated. We believe that wells not near the end of their productive life may tend to benefit, while stripper wells will tend to be adversely affected.

Stripper wells, usually older wells with low production and little remaining depreciable costs, will remain in production only so long as the revenues from the well are greater than operating costs and tax liabilities. If tax liabilities rise, abandonment will occur earlier.

Obviously, this is a very complicated proposal. It includes many factors, but when we balance them all out, it is clear that taxes overall on the oil and gas industry will go up. This increase would clearly cause a reduction in oil and gas exploration and, consequently, in production.

While all estimates must be viewed with caution, our tentative conclusion is that the Treasury tax proposal would cause a decline in production of oil of about half a million barrels a day, and in gas of over a trillion cubic feet per year as soon as 1987.

This would obviously lead to an increase in oil imports and gas imports. Such adverse consequences must weigh heavily in any analysis of the current version of the Treasury tax proposal. The Department of Energy intends to see that they do.

I wish to emphasize again that there is no specific administration proposal with regard to changes in our tax system, but our energy leaders in Government are concerned about the effects the proposal might have were it to become law.

Former Energy Secretary Hodel, now Secretary of the Interior, has said that the proposal would reduce drilling and increase oil imports.

The new Secretary of Energy, John Herrington, is of the same opinion. He also stated at his confirmation hearing that he would be opposing any changes that would lead to a severe crippling of the domestic oil and gas industry. We are confident that these views will be recognized.

The Energy Department is quite concerned that the Treasury's proposal would have adverse effects on businesses involved in oil and gas exploration, production and development, and I assure you that we will do everything we can to see that these adverse effects receive their due weight in administration deliberations.

If I might have one more minute, Senator, I would like to say that I am sure we recognize that Washington is a city of conflicting pressures and it is a difficult place to deal with. When you and I and you return there, I expect that we will have to deal with those who are advocates of the Treasury proposal, who may argue along the following lines.

They may concede that changing the Tax Code would have an adverse effect, but they will maintain that tax simplification will free up capital and channel it into industries where it would be even more productive. The net effect, they say, would be to create a stronger and more productive economy.

Secondly, they may maintain that the Government has meddled in the economy too much, and it is time to let the economy settle out with a Tax Code with no special provisions.

They would have on this argument no particular quarrel with the tax provisions, but feel that simplification means that all features must be simplified.

I raise these two points not because I support them, but because I know they will be raised in Washington. There are many thoughtful people in this room who will appear following me before this Committee, and I for one would certainly like to have the benefit of their thinking on these issues so that the Department of Energy can work with your elected representatives to serve America's interests in energy security effectively and well.

Thank you, Senator. I submit our entire statement for the record.

[The prepared statement of Mr. Boggs follows:]

STATEMENT

OF

DANNY J. BOGGS

DEPUTY SECRETARY

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss the Reagan Administration's tax simplification initiative and our concerns related to its effects on America's energy producers.

As you know, the Treasury Department's tax reform proposal has generated much debate since its submission to the President last November. That was the President's intent. In order to encourage debate and ensure that "all those interested in the subject have the same information we have," President Reagan asked that the Treasury report be made public -- well in advance of any decisions on specific legislative proposals to be sent to Congress. It is in this spirit that I speak to you today: to participate in the public debate over tax reform and share with you information available to us at the Department of Energy.

In his State of the Union Address, the President instructed Treasury Secretary Baker to begin discussions with Congressional leaders toward a bipartisan tax reform bill. The President clearly set forth those principles on which he insists the final proposal be based:

o Tax reform will not be a tax increase in disguise.

o The primary home mortgage deduction will be preserved.

o Personal tax rates will be made as low as possible, by removing many tax preferences.

- The top personal income tax rate will not exceed 35 percent.
- Individuals at or near the poverty line will be totally exempt from Federal income taxes.
- The personal exemption, seriously eroded by two decades of inflation, will be increased.

Of particular interest, I believe, to Members of this Committee, the President said, "[W]e will propose reducing corporate rates while maintaining incentives for capital formation." The President is fully committed to a tax bill which will "mak[e] this economy the engine of our dreams and America the investment capital of the world."

This commitment to economic growth underlies the Administration's tax reform initiative and deficit reduction program. The Department of Energy is currently reviewing the Treasury Department proposal to ensure that any tax simplification legislation does not threaten the essential health of the energy sectors of our economy, especially in view of the capital-intensive nature of those industries and their importance for national security.

I would like to take this opportunity to discuss some thoughts about how the Treasury draft proposal would affect oil and gas exploration and production. Our conclusions are tentative, and we are exchanging information and ideas with the Treasury Department. The views I present are those of the Energy Department; they do not represent an Administration point of view.

Our analysis suggests that the current version of the proposal, by increasing the effective tax rate for exploration and production companies, especially independents, would reduce future domestic production of oil and natural gas, although I cannot say with confidence how much. This reduction in future production would arise from a reduction in oil and gas exploration.

Given the strategic importance of oil and natural gas to our economy and the important contribution by independents to our domestic supply of those fuels, any changes in energy taxation must be undertaken with great care. The Department views with great concern some provisions of the current version of the Treasury tax proposal which we believe need to be revised in order to maintain incentives for capital formation.

The Treasury Department also recognizes the importance of independent producers. While it does not, of course, believe that its proposal would undermine the energy industry, it recognizes that some revisions in the manner in which these provisions may be phased in or even modified, would minimize the dislocation which might othewise arise. On the other hand, its tax reform proposals are based on the premise that fairness, simplicity, and economic growth require taxing all activities in a uniform manner. A case can be made for maintaining the existing incentives fo oil and gas production, and the Department of Energy will make that case.

STRATEGIC IMPORTANCE OF OIL AND NATURAL GAS

An adequate domestic supply of oil and natural gas is vital to the national security and economic wellbeing of the United States. Despite substantial increases in the price of oil and natural gas over the last fifteen years and significant progress by industry and consumers in developing alternative sources of energy and using energy more efficiently, oil and natural gas remain the first and second most important fuels in the U.S. today. In 1974, oil accounted for 46 percent of total U.S. energy consumption. Today, it accounts for 43 percent. In 1974, natural gas accounted for 30 percent of total U.S. energy consumption. Today, it accounts for 23 percent. Together, oil and natural gas account for more than 65 percent of total U.S. energy use. Moreover, about 28 percent of our oil is derived from net imports, while combined imports of oil and gas account for 15 percent of U.S. oil and gas consumption.

Based on our best estimates of future rates of consumption, fuel substitution, and resource depletion , it is our judgment that oil and gas will continue to be major sources of energy for our economy well into the next century. As long as they remain major sources, it is imperative that we maintain an adequate domestic supply of oil and natural gas.

It is true that we are currently experiencing a worldwide surplus of oil and natural gas productive capacity. Energy consumers are benefitting from that surplus, as they should. But it would be extremely shortsighted to use the current surplus as a justification for accepting thoughtlessly a reduction in exploration for and production of domestic oil and natural gas supplies. A significant decline in U.S. oil and natural gas production would increase our vulnerability to oil supply disruptions and artificially high prices. The dramatic response of the domestic oil industry to complete price decontrol, and what has been and promises to be a significant response by the natural gas industry to partial decontrol, should not cause us to forget the enormous costs of past government policies that failed to allow market forces to work.

WHY ARE THE INDEPENDENTS IMPORTANT?

Independent exploration and production companies are an essential part of our domestic oil and gas industry. The independent has consistently played a major role in discovering and producing domestic oil and natural gas. From 1974 to 1983, about 87 percent of all oil and gas drilling was done by independents. This drilling was both high risk exploratory drilling and lower risk development drilling. As a result of this activity, independents accounted for 17 to 38 percent of U.S. oil reserve additions and 33 to 68 percent of U.S. natural gas reserve additions.

The U.S. is a mature petroleum province. Most of the easy, low-cost prospects have already been drilled. In the future, unless a major technological breakthrough occurs, domestic oil and gas will become increasingly more expensive to find and produce. If the Nation is to maintain an adequate domestic supply of oil and natural gas, it is imperative that our oil and gas industry receive an adequate after tax return to compensate for the increasing risks and costs involved in exploration and development.

THE IMPACT OF THE TREASURY PROPOSAL ON OIL AND GAS

Future domestic production will come from three sources:

- future discoveries
- producing properties
- existing properties with enhanced or low level production

Since the Treasury tax proposal would affect each source of oil and natural gas differently, I will discuss the effects of each separately.

THE EFFECT OF THE TREASURY TAX PROPOSAL ON FUTURE DISCOVERIES

The economic value of most future oil and natural gas prospects will fall under the Treasury tax proposal. In the shorter term this may be reflected in lower profits for drilling contractors and for producers. In particular, a few major alterations proposed by the Treasury will significantly increase the tax burdens of producers.

Loss of Intangible Drilling Cost Expensing

The primary concern for all oil and gas producers will be the elimination of intangible drilling cost expensing. The Treasury proposal will no longer allow majors and independents to expense immediately 80 percent and 100 percent, respectively, of eligible intangible expenses. Given the large percentage of drilling costs made up by intangibles (normally 50 to 70 percent), the overall impact of this change will be a large increase in the initial tax burden imposed on future exploration prospects.

Producers are not losing the ability to claim these expenses against further taxes, but are incurring substantial losses in the net present value of the deduction. With recovery of costs tied to production, the recovery of a portion of costs may be postponed as much as twenty years, although most of these costs would likely be recovered within four to five years. Simple discounting shows that the net present value loss attributable to such postponement is significant.

Loss of Intangible Drilling Cost Expensing on Prospects Where Dry Hole Costs Have Been Incurred

Under the proposal, the intangible expenses associated with a dry hole may not be claimed until the entire field or property is abandoned or until successful exploration efforts are followed by actual production and cost depletion can be claimed. By postponing a firm's ability to recover these costs, a firm faces net present value losses equivalent to those addressed previously. If a firm's expectation of success does not exceed the net present value losses attributable to delaying recovery of dry hole expenses, it is in the firm's interest to abandon the property, regardless of whether or not the full resource potential of the prospect has been determined.

Loss of Percentage Depletion

The Treasury proposal eliminates the percentage depletion allowance but continues to allow cost depletion. Percentage depletion allows independent firms to claim tax deductions of 15 percent of annual gross revenues from producing wells. Since percentage depletion allows recovery of more than the actual cost incurred, whereas cost depletion under Treasury's proposal allows for recovery of the actual inflation adjusted costs, cost depletion alone will reduce the amount of deductions that independents may claim. The amount of deductions allowed for non-expensed intangible costs are usually much lower than 15 percent of gross revenue over the life of a well. In addition, it allows recovery at a rate tied to production, usually much slower than that allowed under percentage depletion.

In situations where percentage depletion would be considered more valuable than cost depletion, that is, in prospects where expenses are low or the rate of production decline is slow, it is clear that the expected value of future prospects will fall and as a result some prospects will not be explored or developed. In addition, some existing producing properties will be abandoned sooner than they otherwise would be.

Loss of Other Tax Benefits

Two other provisions of the proposal that will also increase the tax burden on future prospects are:

- repeal of the Accelerated Cost Recovery System (ACRS)
- repeal of investment tax credits.

Under the proposal, ACRS is replaced with a system of declining balance depreciation that spreads depreciation of tangible assets over 12 years rather than 5 years. This postpones the recovery of tangible expenses and increases the cost of capital.

The repeal of investment tax credits, as called for in the proposal, will increase the tax burden further. At present, 10 percent of eligible investment costs (most tangible assets in oil and gas exploration) are applicable as credit against income tax liabilities. Removing the tax credit will directly increase the tax burden on a prospect by the 10 percent of eligible investments.

Benefits of the Treasury Tax Proposal for Future Prospects

Some provisions of the proposal will benefit producers when compared with current tax laws. In the first few years these benefits will only partially offset the negative effects of the proposal described earlier. However, after several years, the tax burden of many producers may be lower than under current law.

Producers will benefit most from the reduction in the corporate tax rate from 46 percent to 33 percent. Of all possible modifications to Treasury's proposal, an increase in the corporate tax rate would have the greatest further adverse effect on oil and gas exploration.

Other provisions of the proposal that have positive benefits include depreciation and depletion basis indexing and repeal of the Windfall Profit Tax. Indexing refers to the adjustment over time of the depreciable value of investments for tax purposes to account for inflation.

Unless oil prices rise significantly, repeal of Tier 3 of the Windfall Profit Tax will provide little benefit to independents or majors. The base price for most, if not all, Tier 3 oil may exceed the market price by 1988, when the Windfall Profit Tax will begin to phase-out under the proposal. In addition, independents are already exempt from paying the tax on Tier 2 oil. The only category of oil significantly affected by phase-out of the Windfall Profit Tax will be Tier 1. Although most of this oil is largely owned by the majors, it will also be somewhat helpful to independents.

Future Prospect Summary

Higher initial tax payments will reduce the net expected value of future prospects and should result in lower future domestic reserve additions and production. While lower domestic production will tend to increase oil imports, any increase in world oil prices would tend to reduce consumption and thus tend to reduce oil imports.

THE EFFECT OF THE TREASURY TAX PROPOSAL ON EXISTING PRODUCTION

The effect of the tax proposal on existing production depends on the age of a producing well. We believe wells that are not near the end of their productive lives will tend to benefit from the proposal, while wells that are near the end of their productive lives will tend to be adversely affected by the proposal.

Producing Properties

Lower tax rates will increase the value of existing properties that have already used all tax credits associated with intangible investments. However, the production response associated with this increase in value may be small.

These properties have already been developed in a way that would maximize their present value by balancing production rates, development costs, and reservoir efficiency. Even if the increased value of earlier production would warrant investments in additional development facilities, other provisions of the proposal discourage such investments.

Existing Properties With Enhanced or Low Level Production

Stripper wells face both incentives and disincentives under the Treasury tax proposal. Stripper wells are usually older wells with low production and little remaining depreciable costs. They remain in production as long as the revenues from the well are greater than the operating costs and tax liabilities attributable to the well. For higher operating cost wells, the proposal may raise the tax liabilities substantially since a large proportion of the wells can only claim percentage depletion and operating expenses of these wells. Therefore, abandonment will occur earlier because the point at which revenues no longer cover operating costs and taxes will be reached sooner. However, for lower operating cost wells, this would be balanced by the lower tax rates. The tax burden on stripper wells operated by major companies, who are not currently entitled to percentage depletion, would fall.

Enhanced oil recovery, attributable to the use of injectants, faces the same problem as stripper wells under the proposal. The proposal to eliminate certain tertiary injectant expensing would increase the initial tax payments due on these wells, but this must weighed against the reduction in tax rates. Investments in future projects may decline and some existing EOR projects may be abandoned at an earlier date.

CONCLUSION

Under the current version of the proposal, the effective tax rate for independent exploration and production companies would increase. For those producers currently facing little or no regular income tax (a not uncommon situation), any additional burden may appear dramatic. This increase would cause some reduction in oil and natural gas exploration and consequently, production. While all estimates must be viewed with caution, our tentative conclusion is that the Treasury tax proposal would cause a decline in production of oil of about one half million barrels per day and in gas of over one trillion cubic feet per year by 1987. This would lead to some increases in oil imports and in gas imports. Such adverse consequences must weigh heavily in any analysis of the current version of the Treasury tax proposal. The Department of Energy intends to see that they do.

I wish to emphasize again that there is no specific Administration proposal with regard to changes in our tax system. I am presenting the views of the Energy Department on the effects of one aspect of the Treasury tax proposal, and since I am not from Treasury, I may not have adequately presented the broader framework which guided the Treasury Department in the development of its proposal.

Former Energy Secretary Hodel has said that the proposal will "reduce drilling and increase oil imports". Secretary Herrington is of the same opinion. Secretary Herrington also stated at his confirmation hearing that he would oppose any changes that would lead to a "severe crippling of the domestic oil and gas industry." We are confident that these views will be recognized.

The Energy Department is quite concerned that the Treasury's tax proposal could have adverse effects on businesses involved in oil and gas exploration, production and development. I assure you that we will do everything we can to see that these adverse effects receive due weight in Administration deliberations in Washington.

At the same time, as I am sure you recognize, Washington is a difficult city to deal with. When I return there I expect to have to deal with advocates of Treasury's proposal who argue along the following lines:

- They concede that changing the tax code will have an adverse effect on key industries such as the oil and gas industry. But they maintain that tax simplification will free up capital and channel it into industries where it can be even more productive. The net effect, they say, would be to create a stronger, more productive economy.
- They maintain that we have let the government meddle in the economy too much and that it is time to let the economy settle out with a clean tax code with no special provisions in it. They have no particular quarrel with the tax provisions that the people in this room are concerned with -- but they feel that simplification means all features of the tax code must be simplified.

I raise these two points because I know they will be raised in Washington. There are thoughtful people in this room, and I would like to have the benefit of your thinking on these issues, so that the Department of Energy can work with your elected representatives to serve America's interests effectively and well.

Senator NICKLES. Thank you, Mr. Boggs. We will include your entire statement in the record.

I also want to thank you and former Secretary Hodel for the support that you have given us on this issue.

I appreciate your participation in this hearing. I think it will be educational for this Senator, and I hope for you as well. I would ask that you and the new Secretary, Secretary Herrington, thoroughly examine the impact of this proposal on our domestic petroleum industry and on our dependence on imports. I would also ask that you make the results known to those in Treasury who seem to advocate a further revision in this proposal.

I also hope that you will join with me and others, when we talk about equity of investments, in reminding the Treasury Department that this is the only industry that has a windfall profits tax. When you add the windfall profits tax, and certainly when you add excise taxes, this is the most heavily taxed industry in the United States.

I think that this is a fact that they have not looked at.

You mentioned your estimates of the reduction of production in oil of about a half a million barrels as early as 1987. Have you projected what it might be by 1990 or 1995?

Mr. BOGGS. Well, Senator, as I indicated, I think any estimates have to be viewed with some caution. We are still in the process of refining them to the point that we would have a complete report of some type for publication. That is one reason that I did not go into any greater detail.

As you go further on in time, it obviously gets harder to project. On the one hand, the effect of a lack of exploration would continue to have a downward effect. On the other hand, the way the tax system works, some of these initial damaging effects may settle out and costs may decrease. So, I cannot really give you a projection further out.

We are continuing to work on it. The further out you go, the more factors you have to analyze, and at this point I don't feel comfortable in going any further out than that, but the damaging factors will continue at work.

Senator NICKLES. There is no doubt that the further out you go, the more speculative your assumptions are, but given the facts that you have admitted—and we will hear testimony from experts today that says investments will decline, and Treasury admits that there will be a decline in oil and gas investments, that means a decline in drilling.

If you have a certain percentage reduction in drilling—and drilling has already declined substantially from last year—if the drilling rate declines further, then you are going to have less production.

I think there is a direct relationship there. It means a greater dependence on foreign oil. What I am concerned about is not just 1987, but 1990 and 1995 as well.

You mentioned in your statement the adverse effect that the proposal would have on stripper wells. In the State of Oklahoma, we have over 70,000 stripper wells.

You mentioned in your statement the possible premature abandonment of stripper wells. Once that well is abandoned, it probably will never be operated again, so that would be oil that for the most part that would be lost and never regained.

That is a loss for our country that I think would be very detrimental.

You also mentioned in the first part of your statement the need for revision of the Treasury proposal. I would hope that those of you in the Department of Energy who are concerned about energy security for our country would look seriously at possible revisions, if not total elimination of the proposal, so that we might have some facts and figures to back up a different approach, if that should be necessary at a later date.

Mr. BOGGS. I think that is exactly right, Senator, and we will be working in that direction.

Senator NICKLES. I will be looking forward to working with you and, again, I appreciate your participation in this committee today.

Mr. BOGGS. Thank you.

Senator NICKLES. Next we have a panel of witnesses. If all of our panelists would join us in these first four seats, please.

We have Jack Graves, who is president of the Oklahoma Independent Petroleum Association; George Singer, who is vice chairman of the Tax Committee, Independent Petroleum Association of America; Bud Stewart, who is president of Energy Producers and Consumers Association from Seminole; and James Stafford, who is executive director of the National Association of Royalty Owners.

For all of our panelists, we have a little timer over here that will be set. We will give each person 5 minutes. There will be an amber light that will come on when there is a minute left, but the sky won't fall if you go above that. That is just for your information.

Also, we have been asked by the press and others that we speak close to the microphone. You have to remember that this is a political chamber, and they are used to people yelling in here all the time.

So, you really need to speak right into the microphone, or the rest of the members and participants here won't be able to hear your statements.

Mr. Graves.

STATEMENT OF J.M. (JACK) GRAVES, PRESIDENT, OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION, TULSA, OK

Mr. GRAVES. Thank you, Senator Nickles.

I am Jack Graves. I have been involved in oil and gas exploration and production for 40 years. I have been an independent oil and gas producer in Oklahoma for 29 years, operating as J. M. Graves Oil Co. and Calumet Oil Co. We employ 110 people and operate approximately 500 oil and gas wells in the State of Oklahoma.

Currently, I am president of the Oklahoma Independent Petroleum Association, and today I am representing the association and its members, as well as myself. To a degree, I believe I am representing domestic oil and gas producers in general.

In addition, the statements I make today also include the consensus of at least 40 independent producers, oil and gas companies that I have personally talked with.

We appreciate very much the opportunity to present our views regarding the proposed Federal tax law changes that affect the independent oil and gas industry.

Senator Nickles, you have demonstrated an awareness and keen interest in the role that the independent oil and gas producers play in the economy of the State and the Nation.

I have often said if OPEC wishes to regain control of the price of oil, they should lower their prices to starve out the domestic industry in the United States. But I am dismayed that Treasury has devised a far more effective plan for the destruction of the domestic industry.

First, I want to show the impact on a single company, Calument Oil Co. We applied the proposed tax changes regarding the intangible drilling costs and percentage depletion to the 1983 tax return.

The bottom line was that the company's 1983 taxes would have been 78 percent higher if the proposed simplified flat tax rules had been in effect at that time. This, of course, would have meant a 78-percent increase in bank borrowings, also, to support the operation that drills approximately 40 wells a year.

So, the flat tax proposals would have caused the reduction in drilling from 40 wells to about 25 wells.

Considering even the current prices of oil and gas, it is obvious that even with the present tax rate, many independents are determining that it makes better economic sense to save their money and not drill at all.

This is especially true of wildcat drilling and long-term payout wells that we have in Oklahoma.

This is the time when Treasury should decrease the taxes to the oil and gas risk taker, instead of increasing taxes.

I realize there is not widespread concern throughout the land as to Calumet Oil Co.'s tax bill, but my point is the higher tax obviously would leave the independents with less capital for drilling efforts. There simply would not be enough cash flow for drilling, completion, taxes and producing.

Apply the same impact to 10,000 other independents and you can visualize the negative effect these proposals would have on the nation's ability to meet its energy needs.

It is obvious that the independent will be forced to drill and complete fewer wells because of his increased taxes. It will not be a case of increased taxes and business as usual. It will be case after case of increased taxes and greatly decreased oil and gas activity.

Many independents will simply not drill at all, but instead will choose to liquidate and slowly deplete their oil and gas holdings. This is exactly what the Treasury bill mandates.

This in turn, however, will greatly reduce the anticipated taxes that Treasury expects to collect, and there would also not be the incentives that we require to continually, day by day, endure the hazard, the risk and the liability and the uncertainty of oil and gas drilling and production.

Remember, independents don't have an unlimited supply of money to dip into whenever needed. Therefore, if there is no tax advantage for drilling and producing, the independents won't drill. If we don't drill, we don't need to produce as much oil and gas. So, why hasten our own demise by paying more and more taxes to

Treasury in return for nothing except the depletion of our own reserves.

For the first time this morning, Calumet Oil Co.'s three surface rigs are in the yards at Pawhuska, OK, this is the first time in 10 years that I know of that there is not work for those rigs.

This is due primarily to the fact that since Secretary Regan's proposals were announced the latter part of November, we have not drilled one single well. Generally, by this time, we would have drilled 10 oil wells, attempted 10 oil wells. But under the proposed rules, we are just going to sit back and wait until we can see the light at the end of the tunnel.

The proposed tax rate simplification is little more than a redundant attempt to balance the budget on the backs of the independent oil and gas producers of this country.

The tax incentives to encourage exploration and development have perhaps been one of the most politically sensitive items in the Federal Tax Code. Since 1913 Congress has realized that paying taxes—that taxpaying oil and gas risk-takers should be provided with special incentives.

We have developed oil and gas reserves at extreme financial risk. The Nation will soon become 50 percent or more dependent on oil and gas.

As you know, we cannot continue to destroy the basic industries of this country. It is not possible that we are going to be able to put the fields, the mines, the workshops, and foreign countries and make this one big environmental pleasure house.

Oklahoma has seen the Trail of Tears, the land runs, the oil booms, the busts, the Dust Bowl migrations, and now it looks as if we are getting ready for probably the biggest relocation and dislocation of all.

Senator Nickles, it is imperative, as you know, that President Reagan be advised of this. I know that you are familiar with this because you are an employer and you know what it takes to make a payroll.

We appreciate everything that you have done for the State and its oil industry, and we do solicit your continued help.

Thank you very much.

[The prepared statement of Mr. Graves follows:]

TESTIMONY PREPARED BY JACK GRAVES FOR PRESENTATION AT THE ENERGY TAX HEARING CONDUCTED BY U.S. SENATOR DON NICKELS IN OKLAHOMA CITY, OKLA.

FEBRUARY 15, 1985

THANK YOU SENATOR NICKELS

I AM JACK GRAVES. I HAVE BEEN INVOLVED IN OIL AND GAS EXPLORATION AND PRODUCTION FOR 40 YEARS AND HAVE BEEN AN INDEPENDENT OIL AND GAS PRODUCER IN OKLAHOMA, FOR 29 YRS. OPERATING CALUMET OIL COMPANY AND EMPLOYING 110 PEOPLE AND OPERATING APPROX. 500 OIL & GAS WELLS.

CURRENTLY, I AM THE PRESIDENT OF THE OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION. TODAY I AM REPRESENTING THE ASSOCIATION AND ITS MEMBERS AS WELL AS MYSELF. TO A DEGREE, I BELIEVE I AM REPRESENTING DOMESTIC OIL AND GAS PRODUCERS IN GENERAL. THE STATEMENTS I MAKE TODAY REPRESENT THE CONSENSUS OF AT LEAST FORTY INDEPENDENT OIL & GAS COMPANIES AND INDIVIDUALS THAT I HAVE PERSONALLY TALKED WITH. WE APPRECIATE VERY MUCH THE OPPORTUNITY TO PRESENT OUR VIEWS REGARDING THE PROPOSED FEDERAL TAX LAW CHANGES AFFECTING THE INDEPENDENT OIL & GAS INDUSTRY.

SENATOR NICKELS, YOU HAVE DEMONSTRATED AN AWARENESS AND INTEREST IN THE ROLE INDEPENDENT OIL & GAS PRODUCERS PLAY IN THE ECONOMY OF THE STATE AND THE NATION. I HAVE OFTEN SAID, IF OPEC WISHES TO REGAIN CONTROL OF OIL PRICES, THEY COULD LOWER THEIR PRICES TO STARVE OUT OUR DOMESTIC INDUSTRY, THEN RAISE PRICES WITHOUT DESCRETION. BUT, I AM DISMAYED THAT OUR OWN GOVERNMENT HAS DEVISED A FAR MORE EFFECTIVE PLAN FOR THE DESTRUCTION OF THE DOMESTIC INDUSTRY.

FIRST, I WANT TO SHOW THE IMPACT ON A SINGLE COMPANY ---

IN MY COMPANY, WE APPLIED THE PROPOSED TAX CHANGES REGARDING INTANGIBLE DRILLING COSTS AND PERCENTAGE DEPLETION TO THE 1983 TAX RETURN. THE BOTTOM LINE WAS THAT THE COMPANY'S 1983 TAX BILL WOULD HAVE BEEN 78 PERCENT HIGHER IF THE PROPOSED SIMPLIFIED FLAT TAX RULES HAD BEEN IN EFFECT AT THAT TIME. THIS WOULD CAUSE A REDUCTION IN THE NUMBER OF WELLS DRILLED FROM 40 TO 25. CONSIDERING THE CURRENT PRICES OF OIL & GAS, IT IS OBVIOUS THAT EVEN WITH THE PRESENT TAX RATE, MANY INDEPENDENTS ARE DETERMINING THAT IT MAKES BETTER ECONOMIC SENSE TO SAVE THEIR MONEY AND NOT DRILL AT ALL. THIS IS ESPECIALLY TRUE OF WILDCAT DRILLING AND LONG-TERM PAYOUT WELLS. THIS IS THE TIME WHEN TREASURY SHOULD DECREASE THE TAXES TO THE OIL & GAS RISK TAKER INSTEAD OF INCREASING TAXES.

I REALIZE THERE IS NOT WIDESPREAD CONCERN THROUGHOUT THE LAND AS TO CALUMET OIL COMPANY'S TAX BILL, BUT MY POINT IS THE HIGHER TAX OBVIOUSLY WOULD LEAVE THE INDEPENDENT WITH LESS CAPITAL FOR DRILLING EFFORTS. THERE SIMPLY WOULD NOT BE ENOUGH CASH FLOW FOR DRILLING, COMPLETION, TAXES AND PRODUCING. APPLY THE SAME IMPACT TO 10,000 OTHER INDEPENDENTS AND YOU CAN VISUALIZE THE NEGATIVE EFFECT THESE PROPOSALS WOULD HAVE ON THE NATION'S ABILITY TO MEET ITS ENERGY NEEDS. IT IS OBVIOUS THAT THE INDEPENDENT WILL BE FORCED TO DRILL AND COMPLETE FEWER WELLS BECAUSE OF HIS INCREASED TAXES. IT WILL NOT BE A CASE OF INCREASED TAXES AND BUSINESS AS USUAL - IT WILL BE CASE AFTER CASE OF INCREASED TAXES AND GREATLY DECREASED OIL & GAS ACTIVITY. MANY INDEPENDENTS WILL SIMPLY NOT DRILL AT ALL AND INSTEAD WILL CHOOSE TO SLOWLY DEPLETE OR LIQUIDATE THEIR OIL & GAS HOLDINGS AND THIS EXACTLY IS WHAT THE TREASURY BILL MANDATES. IN TURN HOWEVER, THIS WILL GREATLY REDUCE THE TAXES EXPECTED TO BE COLLECTED BY TREASURY, AND THERE ALSO WOULD

NOT BE THE INCENTIVES TO CONTINUALLY DAY BY DAY ENDURE THE HAZARD, RISK LIABILITY AND UNCERTAINTY OF OIL & GAS DRILLING AND PRODUCTION. THE BUSINESS IS ENTIRELY TOO RISKY WHEN COMPARED TO OTHER BUSINESSES. REMEMBER, INDEPENDENTS DON'T HAVE AN UNLIMITED MONEY SUPPLY TO DIP INTO WHENEVER NEEDED, THEREFORE, IF THERE IS NO TAX ADVANTAGE FOR DRILLING AND PRODUCING, THE INDEPENDENTS WON'T DRILL- IF WE DON'T DRILL, WE DON'T NEED TO PRODUCE AS MUCH OIL & GAS, SO, WHY HASTEN OUR OWN DEMISE BY PAYING MORE AND MORE TAXES TO TREASURY IN RETURN FOR NOTHING EXCEPT THE DEPLETION OF OUR OWN RESERVES.

THE PROPOSED FLAT TAX SIMPLIFICATION SCHEME FOR OIL & GAS IS LITTLE MORE THAN A REDUNDANT ATTEMPT TO AGAIN BALANCE THE BUDGET ON THE BACKS OF THE INDEPENDENT OIL & GAS PRODUCERS OF THE COUNTRY.

TAX INCENTIVES TO ENCOURAGE EXPLORATION AND DEVELOPMENT OF NATURAL RESOURCES HAVE PERHAPS BEEN THE MOST POLITICALLY SENSITIVE ITEMS IN THE FEDERAL TAX CODE. SINCE 1913, CONGRESS HAS REALIZED THAT TAX PAYING OIL & GAS RISK TAKERS SHOULD BE PROVIDED WITH SPECIAL INCENTIVES. UNFORTUNATELY, THE EXTENT OF THE INCENTIVES HAVE VARIED WITH THE POLITICAL ATTITUDE TOWARD THE OIL & GAS INDUSTRY AND THE PUBLIC'S PERCEPTION AND NATIONAL NEED OF AVAILABLE OIL & GAS RESERVES IN THIS COUNTRY.

BOTH COST DEPLETION AND % DEPLETION PROVIDE AN EQUITABLE EFFORT TO EQUATE THE DIMINISHING ASSET VALUE OF OF DEPLETING OIL & GAS RESERVES WITH THE FIXED ASSET BASE OF CAPITAL IMPROVEMENTS AND EQUIPMENT THAT ARE ALLOWED DEPRECIATION. OWNERS OF DEPLETABLE OIL & GAS RESERVES NOT ONLY DESERVE THE SAME ALLOWANCE GIVEN FOR CAPITAL ASSETS BUT IN ADDITION, THEY DESERVE A TAX ALLOWANCE TO OFFSET THE DEPLETING VALUE OF RESERVES THAT WERE DEVELOPED AT EXTREME FINANCIAL RISK NOT NORMALLY INCURRED IN ANY OTHER

BUSINESS. IF DEPRECIATION IS ALLOWED FOR IMPROVEMENTS AND EQUIPMENT IN ANY BUSINESS, THEN A COMPARABLE ALLOWANCE SHOULD BE GIVEN FOR DEPLETING OIL & GAS ASSETS.

THE EXPENSING OF INTANGIBLE DRILLING COSTS IS ALSO NOT ANOTHER VILE SCHEME TO DEFRAUD THE GOVERNMENT OF TAXES, BUT RATHER AN ACCOUNTING PROCEDURE WHICH IS JUST AS VALID AS DEDUCTING INTEREST PAYMENTS FOR HOME MORTGAGES. IT IS A VALID YEARLY COST OF DOING BUSINESS WHICH RIGHTFULLY SHOULD BE CHARGED OFF THE YEAR IT WAS OCCURRED, JUST AS LEGITIMATE OPERATING COSTS ARE EXPENSED IN ANY OTHER BUSINESS.

THE RECORD IS REPLETE WITH EVIDENCE OF WHAT WILL HAPPEN ECONOMICALLY TO OKLAHOMA IF THESE PROPOSALS ARE ADOPTED.

TO SUMMARIZE BRIEFLY, IN 1969 WHEN % DEPLETION WAS REDUCED BY 5%, THERE WAS A 20% DROP IN THE TOTAL NUMBER OF WELLS DRILLED PER YEAR. THE INDUSTRY DID NOT RECOVER FROM THIS UNTIL AFTER THE EMBARGO OF 1973. THE ELIMINATION OF EITHER DEPLETION OR IDC'S WILL GREATLY REDUCE THE NUMBER OF WELLS DRILLED BY BOTH INDEPENDENTS AND INVESTORS.

IF THE % DEPLETION AND THE IDC'S ARE NOT ALLOWED, IN MY OPINION IN EASTERN OKLAHOMA, (IF THE TREASURY PROPOSALS ARE ACCEPTED AND APPROVED BY CONGRESS) THE NUMBER OF INDEPENDENT OIL & GAS COMPANIES WILL LIKELY SHRINK BY 35%. THOSE REMAINING WILL BE FORCED TO REDUCE THE NUMBER OF THEIR EMPLOYEES 40% AND THE NUMBER OF WELLS DRILLED BY THESE INDEPENDENTS WILL ALSO DECREASE BY 45%. THIS MEANS OF COURSE, THAT WE WILL HAVE GIVEN UP ON ENERGY INDEPENDENCE AND IT WILL ONLY BE A MATTER OF TIME UNTIL THE NATION IS AGAIN 50% OR MORE DEPENDENT ON IMPORTED OIL.

OKLAHOMA HAS SEEN THE TRAIL OF TEARS, LAND RUNS, OIL BOOMS

AND BUSTS, THE DUST BOWL MIGRATIONS AND NOW WE FACE POSSIBLY THE GREATEST DISLOCATION AND RELOCATION OF ALL, THE 1985 Treasury VERSION OF A GREAT SOCIETY DREAM THAT WILL INSTEAD BECOME A NIGHTMARE.

SENATOR NICKELS, WE REALIZE YOU ARE INDEED FAMILIAR WITH THESE PROBLEMS. YOU KNOW WHAT IT TAKES TO BE AN EMPLOYER - TO MAKE A PAYROLL. WE APPRECIATE EVERYTHING YOU HAVE DONE FOR THE STATE AND ITS OIL INDUSTRY. WE DO SOLICIT YOUR CONTINUED HELP IN PRESENTING THE FACTS TO CONGRESS THAT TREASURY'S PROPOSALS ARE INDEED GAMBLING WITH THE FUTURE AND SECURITY OF OUR COUNTRY.

THANK YOU.

JOE VIZCAYA

Application of Treasury Department's Proposed Tax
Reforms to 1983 Information

	1983 Return as Filed	Alternative I Application of Treasury Proposal to 1983 Facts	
Taxable Income Per Tax Return Filed	$2,014,493		$2,014,493
Increases (Decreases) to Adjusted Gross Income			
Adjustments to Conform w/Treasury Proposal			
Schedule C			
Loss of Percentage Depletion		1,207,926	
Cost Depletion on Capitalized IDC (estimated 10% rate)		(107,981)	
Loss of IDC Deduction		1,079,807	
Schedule D			
Additional Capital Gains Due to Elimination of Capital Gain Deduction		50,917	
Adjustments to Reflect Elimination of Drilling Activity			
Schedule C			
Remove Intangible Drilling Costs		N/A	
Remove Dry Hole Costs		N/A	
Remove Depreciation on Equipment Associated with Drilling Cost Rate (1,125,000 x .15)		N/A	
Total Increase (Decrease) in AGI	-		2,230,669
(Increases) Decreases in Itemized Deductions			
Adjustments to Conform w/Treasury Proposal			
Taxes - Elimination of State and Local Tax Deduction		186,553	
Contributions		11,450	
Total (Increase) Decrease in Itemized Deductions	-		198,003
Increase in Personal Exemptions	-		(2,000)
Adjusted Taxable Income	2,014,493		4,441,165
Estimated Federal Tax	868,555		1,548,552
Increase in Federal Tax Over 1983 Actual	-	78%	679,997
Net Increase (Decrease) in Cash Flow Over 1983 Actual	-		(679,997)

Senator **Nickles**. Thank you very much, Mr. Graves.

Bud Stewart is president of Energy Producers and Consumers Association of Seminole.

STATEMENT OF E.L. BUD STEWART, JR., PRESIDENT, ENERGY CONSUMERS AND PRODUCERS ASSOCIATION, SEMINOLE, OK

Mr. **Stewart**. Thank you, Senator. We certainly appreciate this opportunity to present our views.

The Energy Consumers and Producers Association is made up of some 800 independent oil and gas operators and royalty owners throughout the country.

The independent operators of ECPA's membership own outright from 2 to 20 barrels a day of production. They may operate more, but that indicates, I think, how small they really are. We represent the small independents.

Also, I have been involved in the oil and gas business for more than 25 years here in Oklahoma.

I would like to summarize my testimony by starting and telling some of the predictions that the Federal Government has made in the past.

The Interior Department years ago made the statement that no oil would be found in east Texas. The Geologic Survey made the statement that biological conditions west of the red beds in Oklahoma around Chandler were not conducive to the accumulation of hydrocarbons.

Of course, we recognized east Texas was the biggest pool in the world until a number of years ago; and the Anadarko Basin and the Sooner Trend and a few other producing areas are west, including Oklahoma City.

Another prediction that a high political official made not too many years ago, and you may recall this, Senator, was that we should not let private enterprise develop the vast oil resources off the Atlantic coast. That should be reserved for all the people of the United States, instead of giving it away.

And as you may recall, 30 holes are testimony, all dry, that perhaps that prediction was also wrong.

It brings me to the point that the Treasury, in issuing their various statements, have made some rather outlandish predictions.

First of all, they say that too many unprofitable wells have been drilled in the United States. They have also said that what we need to do, rather than test by drilling, we need to increase the use of seismic survey.

They have also said that they really were not very much impressed about the national security aspect of the proposal that they are suggesting.

Well, let me just discuss one pool, the Pecan Grove Pool. It is a recent pool discovered in Oklahoma, 3,500 feet. It has 13 producing wells and 9 dry holes. That is a relatively high percentage of dry holes for a development site.

But even so, it is around 76,000 barrels average for all 22 wells and 1,365 million cubic feet of gas reserve. That is approximately 1.69 million barrels of oil, which represents one-fifth of 1 day's domestic production, just from 1 small pool.

Seismograph did not locate that pool, and there are hundreds and hundreds of other examples. In fact, if the Treasury would like to talk to the Geological Association, I am sure they would learn that for 125 years in this country we have been concentrating on finding oil in stratigraphic traps rather than structures. That is, onshore, not offshore.

Those stratigraphic traps did not lend themselves to seismic exploration. So, the Sooner Trend is a good example. There are three or four zones right here in Oklahoma, and it goes for miles and through several counties, all stratigraphically trapped, and seismic wouldn't have found it.

So, I don't think that Treasury, if they really looked at their proposal, would say that we ought to forego that type of production.

Also, I think the strategic aspect of their statement is silly on the surface. Otherwise, why would Congress have allowed $15 billion to have been spent to put oil in the strategic petroleum reserves if national security wasn't some factor in the whole equation.

The independent response to the drilling since 1979 has added 1.1 million barrels of oil a day to the production in this country. From 1981 to 1983 we have added 750 million barrels of oil to our reserve, which is considerably more in a much shorter period of time than went into the strategic petroleum reserve.

Senator, I think what we have here, and we have had for many years, is a basic misunderstanding of what our business is all about. It seems as though we tell them and tell them and tell them, and there is no way that it really comes through.

I have tried to look at it from Treasury's viewpoint and say what sort of other industry can we compare it to, something they would know about. The only conclusion I have come to is that we are probably closer to research and development type of business than any other.

I have a slight example here. It is an experience I had. We just finished drilling a well, the Sterling No. 1. It had five zones and three of those zones were dry. They were all tested after pipe. We finally completed two zones.

Now, under their proposal, the testing that we did on three dry zones, each one of which had been drilled as an individual well, would have been a dry hole and could have been written off, but because that well is going to produce, even though very marginally, they say we have to capitalize those costs which are dry hole costs. And I certainly don't think that is fair.

In my testimony, and it is a very simple example, I have tried to compare investing $230,000 in an oil well, producing oil well in Oklahoma, against $100,000 invested in a condominium for rent.

The comparison is essentially this: In 18 years, with no tax consideration at all, no depreciation, no interest consideration, in 18 years the condo would give you $412,000; the oil well, with 70,000 barrels reserve, 4,600 feet, would give you $464,000 return or more, not including taxes.

But then let me ask the Treasury, what is the risk. Against that $464,000 of income, you really ought to apply 30 percent risk factor and reduce that, because you are going to drill 1 30 percent dry hole.

So, how do you overcome that, and how are you also going to overcome the fact that rather than have that well produce $464,000 in 18 years like the condo, it may take 25 years, which would further depreciate it.

Those are risk factors. Naturally, if we got it all back in 5 years, we would be much better off. So, I think that there is a basic misunderstanding, and I would hope that we would have an opportunity to consider how you figure risk before their proposals go much further.

Thank you very much.

[The prepared statement of Mr. Stewart follows:]

STATEMENT BEFORE
COMMITTEE ON ENERGY
AND
NATURAL RESOURCES
UNITED STATES SENATE

E. L. Bud Stewart, Jr. President
Energy Consumers and Producers Association
P. O. Box 1726
Seminole, Oklahoma 74868

February 15, 1985
Oklahoma City, Oklahoma

"No oil will ever be discovered in East Texas." "West of the red clay beds of central Oklahoma geologic conditions will not permit accumulation of hydrocarbons." "By 1986 crude oil will be selling for $65 per barrel and by the 1990's the price will be $100 per barrel." "The oil fields off the Atlantic coast should be developed for all the people, not afew oil companies." At one time or another federal government agencies or top officials have made the above statements. Of course, East Texas became the biggest oil field in the world; the Oklahoma City, Anadarko Basin and Sooner trend fields are all west of the red clay beds; the price of oil in 1986 will be much closer to $20 per barrel than $65 and $100 oil may come about only in the next century; and, some 30 dry or non-commercial holes have been drilled off the Atlantic coast. This area may never produce.

With the federal government's highly suspect track record at predicting the future of the oil and gas business, I believe statements recently made by officials of the Treasury Department promoting tax reform proposals should be closely scrutinized and challenged.

The stated thrust of Treasury's proposal to eliminate the percentage depletion allowance and the immediate expensing of intangible drilling costs is that the industry drills too many unprofitable wells; more emphasis on seismic technology would reduce the need to test by drilling; and, national security aspects of domestic energy supplies are exaggerated. (Exhibit "A").

On all three counts I submit Treasury's logic is faulty. The part the independent operator plays in the total domestic industry is well documented. The Energy Consumers and Producers Association has a membership of some 800 independent operators. They own no refineries or marketing facilities and only a very few own even gas gathering systems. Most own outright no more than an average of 2 to 20 barrels of equivalent oil production per day. Taken one by one these independents and their contribution to the 8 million barrels per day of the U.S. production is indeed insignificant, but combined into 8,000 of their number and the countless other thousands who join their drilling efforts as investors the independents have drilled the U.S. out of the precipitous decline of oil and gas reserves experienced in the early 1970s. It is estimated that except for the drilling response by independents, domestic production today would be 1.1 million barrels per day below 1979 levels. This remarkable increase of the U.S. ability to produce is a direct result of the increased number of wells drilled. There has always been a direct relationship between the number of wells drilled and daily average production. Several years ago, before Congressional Committees, numbers of the Association testified that the energy policy goal of the U.S. should be to encourage the drilling of 80,000 wells per year. In recent years the industry has achieved that rate and there has been a production response. Contrary to Treasury's premise, I know of no operator who deliberately starts out to drill unnecessary or unprofitable wells. Unfortunately, some turn out that way but in the mix over the period 1980, 1981, 1982 each oilwell has added an average of 70,000 barrels to our reserves and each new gas well has added over 1 billion feet of gas to the domestic reserves.

Many of the recent field discoveries have found production in strategraphic traps as opposed to structural traps. Generally strategraphic traps are not conducive to discovery by seismic methods. The new Pecan Grove Pool in Oklahoma with which I am familar with contains 13 producing wells and 9 dry holes; a 40% dry hole rate and yet each well will average over 76,000 barrels of oil and 136 MMCF gas reserves which is good production for shallow 3500 foot wells. The reserves of this small pool is only 1.69 million barrels but this will represent almost 21% of one days domestic U.S. production. This field would not have been discovered by seismic technology. In fact, for the past 25 years there has been ever increasing emphasis on exploration for strategraphic traps on-shore because the large structures in accessable areas have already been discovered. The large Sooner trend extending from Oklahoma City northwest through several counties and containing literally thousands of wells is a good example of large strategraphic traps in multiple producing zones. Surely Treasury would not want us to forsake this type of production in the future!

There is very little which can be said about the national security aspect of domestic production that has not already been said by the Congress in enacting past legislation. If national security counts for so little, perhaps Treasury should explain why the federal government has spent $15 billion to put 500 million barrels of oil in the Strategraphic Petroleum Reserve? In 1981-1983 independents alone added almost 750 million barrels to our domestic reserves.

The concept of the depletion allowance first appeared in tax law in 1913 and intangible drilling costs as an expense item in 1918. Thus, over the past 70 years, in one form or another, Congresses have reaffirmed the policy to provide incentives to encourage taking the risks inherent in oil and gas drilling investments. Over the years the incentives have worked remarkably well to guarantee domestic supplies. It is not by happenstance the U.S. has consistently been the largest producer of crude oil in the world. Perhaps the saying "if it ain't broke don't fix it!" should apply to the oil industry.

In previous testimony at this hearing and at other hearings, the industry has documented the employment and production loss should depletion and IDCs be eliminated and I do not want to belabor these points.

The basic problem is to reach some understanding which fairly describes the oil and gas exploration business. In many respects drilling wells is like research and development expenses. There seems to be general acceptance that expenditures made by firms to develop new products are indeed expenses subject to special tax write-off treatment. Thus firms are not penalized for the trial and error phase of product development. There is much in the process to get a well to produce which is trial and error. Aside from the fact that some 30% of all development wells are dry holes and a total loss, there is a wide variance in the degree of profitability of those which do produce. Rarely are offset wells completely predictable.

Recently I participated in drilling a wildcat shallow well which provides a case in point. The primary objective of the Wilcox formation at 2800 feet was dry, however, the well log indicated four upper zones which had promise. None had been drill stem tested. At this point all costs except 600 feet of surface pipe were IDCs. If the decision is made to run casing to attempt to complete the well, much of the costs are treated as capital expenditures. The decision was made to attempt completion. The Lower Dutcher was perforated but gave up salt water. The Middle Dutcher was perforated and gave up some gas. This zone was fracture treated but turned out to be non-commercial. The Upper Dutcher and Booch were perforated and treated on a commingled basis and will produce some 250 MCF of gas and about 3 barrels of oil per day. This will be a very marginal producer and will probably not merit additional drilling. Under present law all expenses to date in this real life example except for surface and long string casing are treated as IDCs. However, under the Treasury proposal all costs would have to be capitalized and recovered over the life of the wel,. Thus, the expenses of penetrating and testing the dry Wilcox and attempting completion in the dry Lower and Middle Dutcher zones must be capitalized even though they have no value and proved to be an absolute loss. Knowing the production histroy of these zones in this particular area, I can assure you the decision to "dry hole" the entire project and take the loss would have been made if Treasury's rules had existed at the time this well was drilled. There would be no small gas well to add to the U.S. reserves. I believe this example indicates the experimental nature of much done in the business. Yet someone sitting in Washington would note only that the Sterling #1 was completed as a producing well and thus all costs should be capitalized.

Oil and gas operations must compete with all forms of potential investment for capital. In comparing investment opportunities, investors must consider the risks involved. Exhibit "B" attempts to compare opportunities without regard to tax consequences or the value of money.

The examples used compare an investment of $230,000 in the drilling of an oilwell with an investment of $200,000 in a condominium for rent. The oilwell investor stands to make $464,000 profit over the life of the well and the real estate investor $412,000 after sale of the property in 18 years. Obviously it is difficult to make such abstract comparisons, but many people make decisions daily on just this type of information. One might conclude that if the choice were between these two investments, the best investment would be the oilwell since there was $52,000 more return even though the cost was higher. But that decision would not take into account the investor runs a 30% chance to lose much of the $230,000 if the well is a dry hole or more than likely most of the entire investment if the producing formation is such that it will yield only 10,000 barrels instead of the projected 40,000 barrels of oil. Moreover, it is difficult to predict how long it will take to recover the oil. If the well could produce the 40,000 barrels in 5 years, the investment would be enhanced, but supposing it took 25 years to yield the oil.

On balance, I believe the investor would be wise to put his funds in the safety of real estate. Of course, if there was a tax advantage to encourage drilling the oilwell, then perhaps the uncertainty could be offset.

Exhibit "A"

Treasury official defends plan for big revamp of tax regime

Arguments put forth by the Independent Producers Association of America to oppose the Treasury Department's tax reform proposals are not correct, says Treasury Deputy Sec. R. T. (Tim) McNamar.

The proposed tax plan will not, as argued by IPAA, decimate the ranks of independent producers and will not threaten U.S. energy security, McNamar told a session sponsored by Rotan-Mosle Inc. last week in Houston.

The plan, as currently proposed, would repeal percentage depletion for oil and gas, expensing of intangible drilling costs, and expensing of tertiary injectant costs (OGJ, Dec. 3, 1984 p. 46).

Responding to IPAA. McNamar said IPAA believes the proposed flat rate tax will eliminate all tax shelter investment, and one third of internally generated funds spent on drilling will go to higher tax liabilities.

"IPAA says drilling ventures will fall 50%," McNamar said.

"But the level of tax shelter investment already has fallen dramatically. My numbers suggest from a high of $14 billion in 1981 to $1 billion in 1984.

"We didn't cause that.

"To suggest that these remaining funds would disappear as a result of Treasury's proposals implies that the investment would not have been profitable were it not for the special tax benefits allowed under current law.

"We do not believe it is in the nation's best interest to have the tax laws encourage investment in otherwise unprofitable activities."

McNamar said IPAA's idea that internally generated funds would fall by one-third is too pessimistic.

"Calculating the effect of the repeals and lower rates," McNamar said, "we estimate a less than $3 billion increase in tax liabilities, pro forma 1984, which is only 10% of the $30 billion of funds generated internally by independent producers.

"This is based on numbers we got from IPAA. This is the way we're looking at it. If we're not doing it right, somebody will have to show it to us."

Marginal ventures. McNamar said that while Treasury's proposals may hurt the profitability of some marginal ventures, they will increase the profitability of others.

He said, "We analyzed the impact of Treasury's proposals on a drilling venture by a small independent oil and gas company using data provided by IPAA.

"We found that the internal rate of return would in fact increase by 22%.

"This may not mean anything to a producer determined to drive his tax liability to zero by drilling a well regardless of the expected return, but it should mean something to producers concerned about the profitability of their investments."

McNamar said IPAA claims the tax plan would have reduced 1984 drilling by 30,000 wells and driven 4,000 independent producers out of business, thereby increasing dependence on imported petroleum from one third to one half of U.S. consumption.

He said, "Independent producers produce about 25% of the nation's oil and 40% of its gas.

"Even if it were assumed that the decline in drilling investment matched the 10% reduction in internally generated funds, at today's prices we estimate that independent producers would produce about 6.4% less oil and 5.5% less gas."

McNamar believes the resulting increase in oil imports will be far less significant than what IPAA has suggested.

Advice from industry. Treasury needs advice on its proposed flat tax plan from industry because, McNamar said, Treasury may be wrong in its assumptions.

"We need to have someone walk through the figures with us to make sure our numbers are right. We need to get that kind of quantitative analysis and exchange of data to make sure that we know what, if any, changes we have to make."

He said the weakest part of the flat tax plan is the transition rules.

"We need industry to work with us on the transition rules," he said. "We need your analysis."

McNamar said the proposal will have some type of grandfather clause to protect outstanding investments.

"We don't want, to the extent possible, to hurt people who have made investment decisions given the current tax code."

However, he added, that's not always possible.

He said the Reagan administration's goal is a tax that puts into place the concept that families and businesses with equal incomes pay about the same taxes.

R. T. McNamar
He opposes tax laws that hike investment in "otherwise unprofitable activities."

The current code, he said, provides several preferences to the petroleum industry that don't reflect true economics.

"As an example of the nonrelationship between economic returns and after tax returns," he said, "in 1983 oil and gas partnerships reported $32 billion in losses for tax purposes but had a positive cash flow of $76 billion."

McNamar believes President Reagan will endorse the major concept of Treasury's tax plan during his State of the Union address scheduled for Feb. 4. However, McNamar said, Treasury won't have its final recommendations ready at that time.

He expects an administration bill to be submitted to Congress by the end of February or early March. Congressional committee hearings would begin in March.

McNamar, based on his impression that initial reception of the plan from Congress has been good, expects a bill to be signed into law during the summer. •

Exhibit "B"

Investment Comparison:

1. Average Oil Well:

This example assumes an oilwell found reserves of 40,000 barrels which is slightly higher than the average reserves added in 1982. The oil sold for a price of $25 per barrel after windfall profits tax. This example applies a risk factor by reducing the anticipated net proceeds.

Gross revenue		$1,000,000
Less 20% royalty	-	200,000
Less 7% state tax	-	56,000
Less well cost @ $50/ft.	-	230,000
Less operating cost	-	50,000
Net revenue		$ 464,000
Risk 30%	-	139,200
Net profit		$ 324,800

2. Rental Condominium:

This example requires a $200,000 investment in a condominium; 13% return on investment; and, 18 year ownership.

Gross rental revenue	-	$ 468,000
Less taxes $1,000/yr.	-	18,000
Less operating $1,000/yr.	-	18,000
Operating revenue		$ 432,000
Less cost of condo	-	200,000
Net revenue		$ 232,000
Sale of condo		180,000
Net profit		$ 412,000

Senator NICKLES. Thank you very much, Mr. Stewart.

Our next panelist is Mr. George Singer, vice chairman of the Tax Committee, Independent Petroleum Association of America.

STATEMENT OF GEORGE A. SINGER, VICE CHAIRMAN, TAX COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, TULSA, OK

Mr. SINGER. Thank you, Senator.

My name is George Singer, and I am a partner in Singer Brothers, independent oil producers out of Tulsa.

The Treasury proposal purports to be a proposal which promotes fairness, simplicity, and economic growth. I would suggest to you, Senator, that if you analyze the proposal in some detail, you will find out that simplicity is really not one of the features that is encouraged, particularly if you look at the features which talk about capitalization of indirect costs, including interest, and some of the indexing features. It will be an exceedingly complex proposal.

I believe that when we are discussing this proposal from the viewpoint of the oil and gas industry, however, we should not make statements arguing against the proposal when the proposal itself acknowledges those statements.

Rather than saying, "This proposal is going to reduce the production of oil and gas," that is understood. You have acknowledged that in your statement earlier, Senator.

What we need to do is to be able to establish why that is bad, focus on the consequences of reduced production, rather than simply establishing the fact of reduced production, because it is clearly stated in the proposal itself that this will have that effect. I think that is an important statement that needs to be made.

I would suggest to you, all of you here, that this proposal is based upon faulty assumptions in a lot of areas, not just as far as it applies to the oil and gas area.

One of the assumptions is that we should in the U.S. play on level playing fields, as far as taxes are concerned.

There are references in the proposal to the global economy, but there is no acknowledgement that the level playing field that we would play on in this country is not going to be matched by level playing fields in other countries that we are going to have to compete with in the global economy.

And that is a very, very important distinction. There are many areas in which, by putting ourselves in one posture, we will be disadvantaging our own citizens relative to foreign competition.

There is also an assumption that there is a perfect market as far as the economy of the United States is concerned, but money cannot simply flow out of one area of investment into another. All the people in this room who are oil and gas operators can't just say, "OK, I am going into the grocery store business. I am going to do something else." You can't do that tomorrow.

The transition period is a very long period from investment in one area into another. These things don't just happen magically.

Moreover, there is an assumption and acknowledgement in the proposal that there will be shifts in employment from one economic area to another; but you cannot simply close a steel mill in Pittsburgh and expect all the people to relocate in southern California the next month.

Life doesn't work that way, and sometimes these things are thought of in the vacuum of some economist's mind. Life simply has other realities. People grow up and live in various places and develop attachments, and we don't have that kind of fluid movement back and forth in our country.

I think we would be shortsighted if we don't recognize the broad momentum that has built up for tax reform in this country. There is not just the Treasury proposal, but as you know, Senator, there are very many other tax bills that have been introduced; and with the exception of the Roth-Moore bill, none of the bills retain the major incentives for the oil and gas industry.

It is important that we understand that this is not just the Treasury proposal that we are dealing with. We are dealing with a broad movement, and it is a philosophical movement toward tax reform. And some of the features of this movement are similar in every one of these bills, even where the details differ.

So, we cannot simply say, "Well, we are going to defeat the Treasury proposal and that is it." We need to understand that we are facing a very significant amount of momentum that is coming from many, many sides of the political spectrum.

One of the issues that Mr. Graves raised was how much his tax bill would be raised, and I think that it is appropriate for us to understand that; but again, we need to understand it in the context in which he placed it.

Paying more taxes is by itself not necessarily bad. None of us like to pay taxes. But what we want to do is recognize what happens when we pay more taxes. When we pay more taxes, we have less money to invest in oil and gas exploration.

Mr. Graves estimated that his drilling of wells would be reduced from 40 to 25 wells. It is important to keep in mind that the independent oil and gas—that sector of the oil and gas industry has historically invested over 100 percent of its wellhead revenues.

If you reduce the wellhead revenues from a net viewpoint, either by reducing the price, which is happening already, or by adding a tax burden, which is a cost of doing business, you are going to continue to reduce the amount of drilling in exactly the same kind of ratio that Mr. Graves indicated, and it is something that we cannot say, "Well, we would have invested the money." We have shown that we do invest the money and continue to do that.

One of the points that the President made in his State of the Union speech was not only that we wanted to promote through this tax package capital formation, but we want to also promote investment.

Capital formation is only an interim step to capital investment. This bill does, I think—this proposal—it is not in bill form. The proposal does very much look toward capital formation, but it creates severe disincentives to capital investment in most capital intensive industries.

I think that not only the oil and gas industry, but many other industries are going to find that no one is going to want to put any money into it after this kind of proposal gets to the forefront.

In closing, I would like people to recognize that Secretary Weinberger in his recent statement that he made in an interview on cable news network said, "We cannot reduce the defense budget. If we do, we have got to understand that every billion dollars taken out of that budget is going to cost us 90,000 jobs."

Ninety thousand jobs, based upon an industry which is probably not significantly more labor intensive than the oil and gas industry is a good figure to focus on.

We are going to have people who are going to be before you later this morning, I am sure, who are going to talk about the number of jobs that Oklahomans are going to lose. That is an important part of it, but through the economy as a whole, through all the producing States, we are going to be talking about a lot more than 90,000 jobs, and these are not going to all be people who are directly employed in the oil and gas industry.

There are a lot of collateral effects that this is going to have, and we need to understand that it is not only these economic theories that are involved, but there are human lives that are affected by these proposals.

Thank you very much.

Senator Nickles. Mr. Singer, thank you very much.

Our next panelist is James Stafford, the executive director of the National Association of Royalty Owners, from Ada, OK.

STATEMENT OF JAMES L. STAFFORD, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF ROYALTY OWNERS, ADA, OK

Mr. Stafford. Thank you, Senator.

We represent 5,000 individual members in 50 States, and an additional 30,000 associates that belong to us through affiliated State and regional royalty owner groups throughout the Nation.

About 260,000 royalty owners of oil and gas interests in Oklahoma and 2.5 million nationally would eventually suffer a severe loss of income if this proposal by the Treasury Department were backed by President Reagan and passed by Congress.

Incidentally, the facts and figures the IRS furnished the Treasury Department, in order to draft this, lumped us along with the independent producers, and this led to some dangerous conclusions. While it was flattering from a financial viewpoint, it is kind of like perfuming the hog, in a way, from a financial viewpoint.

But it would be impossible under this proposal for 90 percent of Oklahoma royalty owners to shift to a cost depletion basis, as proposed by the tax bill.

The bulk of mineral interests in Oklahoma has been held by family farm-ranch groups, small investors, and have been fragmented virtually hundreds of times by deaths and assignments for many generations.

Thus, there is no logical and computable cost basis. This thus would prove an administrative burden and impossible for compliance for very many elderly people, who have neither the access nor the financial ability to retain Peat, Marwick and Mitchell on a routine basis. That is about what it would take.

This proposal would cost royalty owners throughout the Nation an estimated $112 million yearly from stripper well production alone, and according to the figures furnished us by Congressman Wes Watkins' office, I might add, if they are correct, show that it would cost $6 billion to royalty owners over the next 5 years. That figure was researched by the Library of Congress for him, and I think it was released last week.

Nowhere does this anticipate the mass abandonments that we have heard about of marginal wells in the depressed areas of the State.

You were in Pontotoc County several days ago. I was standing next to an operator who estimated then that 41 percent of the stripper wells he operated would be abandoned in the near term under this proposal.

The average production in that county is 2.7 barrels a day. This would amount to a loss of $12 million yearly from his production alone, for the county. That is triple the payroll of the county's largest industrial employer from an economic viewpoint.

It should also be noted, as Bud Stewart said several times in prior sessions, that abandoned wells pay no taxes.

The proposal would also gut the intangible drilling cost allowance, which is the prime stimulus for exploration capital in this State among the independent producers. It would evaporate lease activity, thus bonus and delay rentals on undrilled minerals, which is another gut shot to the farmer and rancher in the State.

First we had, those of us in farming and ranching had low prices, bad weather, and high interest. Now we also have the U.S. Treasury and Mr. Stockman of the Office of Management and Budget shooting at us.

The other day he called us nonproductive and said there was too many of us, that we are all out to make a killing. I just throw this in, that we have three-tenths of 1 percent of all the world's farm population, but we account for almost 40 percent of the world's agricultural needs. I wish Mr.Stockman would get that message.

The proposal would also kill incentives for enhanced recovery, the only hope for all royalty owners living in mature producing regions. This covers about 80 percent of the Nation's productive regions.

In Oklahoma this would amount to a bare-bones minimum loss of royalty of $22 million yearly, and the multiplier effect would gut the rural economies of a hard-needed $90 million.

We have some data that was researched by Mary Badgett, who is a CPA in Lubbock, TX, that shows that contrary to the administration's projections, the so-called Reagan proposal would increase taxes on middle-income royalty owners the hardest and afford needed relief only for royalty owners with minimal incomes and a small Social Security, in deference to the new credit offered the elderly.

I had hoped to have this computer study here today. It will be reproduced later, next week, and furnished. It shows some fairly revealing statistics.

I have received by phone three examples that show some of the inequities here. A widow over 65 years of age with $15,000 royalty income yearly and Social Security of $6,000 yearly would have a tax increase of 31.28 percent under this proposal. A married couple with $25,000 gas royalty income and Social Security of $6,000 would have a tax increase of 26.93 percent. The same couple, however, with $100,000 gas income would have a tax increase of only .03 percent.

So, there is some rambling inequities in the proposal, and it shows from our data that the royalty owners of natural gas would fare quite differently and worse than those of oil. That is because that commodity is not subject to Windfall Profits Tax, which allegedly will be phased out under this proposal.

We think that while we endorse the elderly credits, there is no doubt about it, we feel this entire plan is a kind of bureaucratic insanity in that, in a sense, that any benefits that will be gained will be immediately destroyed by lack of production, particularly in the mature producing areas.

So, I hope that this committee can spare the industry any further tax tampering and get on with the larger priority of promoting energy independence by affording a fair dollar for the massive risks inherent.

Thank you very much.

[The prepared statement of Mr. Stafford follows:]

Testimony of
James L. Stafford,
Executive Director of
The National Association of
Royalty Owners
on
Percentage Depletion
before
Senate Committee on
Energy and Natural Resources

Over 300,000 royalty owners of oil and gas interests in Oklahoma and 2.5 million nationally would eventually suffer a loss of income, $6 billion, if a proposal by the U.S. Treasury Department to kill percentage depletion were backed by President Reagan and passed by Congress.

The facts and figures the Internal Revenue Service furnished the Treasury Department lumps royalty owners with independent producers. This error results in dangerously misleading conclusions which could be likened to pouring perfume over a hog.

It would be impossible for 90 percent of Oklahoma royalty owners to shift to a cost depletion basis, as proposed by the tax bill to compute taxes. The bulk of mineral interests in Oklahoma has been held by family farm-ranch groups, small investors, and fragmented by deaths and assignments, for many generations. Thus, there is no logical and computable cost basis. It would thus prove an administrative burden and impossible for compliance. Further, the bulk of royalty owners have neither the access nor the financial ability to retain Peat, Marwick, and Mitchell on a routine basis.

The proposal would cost royalty owners throughout the nation an estimated $112 million yearly from stripper well production alone and an estimated total of $6 billion lost to royalty owners over the next five years.

Nowhere does the Treasury Department proposal anticipate the mass abandonments of marginal wells in the depressed areas of the state, where average production (such as in Pontotoc County) is 2.7 bbls. a day. One operator told me yesterday that under the Administration proposal, he could expect to abandon 41 percent of the stripper wells he operates in the near term, for a loss to the county of $12 million yearly, which is more than triple the payroll of the county's largest industrial employer. Contrary to rumor, there is a point where a well becomes a loser, and few are in the business as a hobby. It should also be noted that abandoned wells pay no taxes.

The Treasury Department's proposal also would gut the intangible drilling cost allowance, which is the prime stimulus for exploration capital in this state among the independent producers. This would evaporate lease activity, thus bonus and delay rentals on undrilled minerals, another shot to the gut of the farmer and rancher of the state. First, those of us in farming and ranching had low prices, bad weather and high interest. Now, we also have the U.S. Treasury and Mr. Stockman, of the Office of Management and Budget, shooting at us. He calls us non-productive, too many, and out to make a killing. For the record, the United States has only 3/10ths of 1 percent of the world's farm population, but we account for almost 40 percent of the world's agricultural needs.

The proposal would also kill incentives for enhanced recovery, the only hope for all royalty owners living in mature producing areas, which cover about 80 percent of the nation's productive regions.

In Oklahoma this would immediately amount to a bare-bones minimum Q.1. loss of $22 million yearly and the multiplier effect would gut the rural economies of a hard-needed $90 million. Our attached data, researched by Mary Badgett, a CPA, and her staff in Lubbock, Texas, shows that contrary to the Administration's projections, the so-called Reagan proposal would increase taxes on middle income royalty owners the hardest and afford needed relief only for royalty owners with minimal incomes and small social security, in difference to the new credit offered the elderly.

The NARO computer study is computed on $28.50 per bbl. oil, and compares the existing tax status with that proposed tax plan of the U.S. Treasury Department. Following are examples from that study:

* A widow over 65 years of age, with $15,000 of oil royalty income yearly and social security of $6,000 yearly,would have a tax increase of 31.28 percent under the Treasury Department's proposal.

* A married couple with $25,000 of gas royalty income and social security of $6,000 would have a tax increase of 26.93 percent.

* The same couple, however, with $100,000 of gas income would have a tax increase of only .03 percent.

The rambling inequity of the ~~study~~ proposal shows that royalty owners of natural gas would fare differently and worse than those of oil. That commodity is not subject to the windfall profits tax, which allegedly would be phased out under proposals by the Treasury Department.

The new three bbl. a day exemption relieves well over 80 percent of royalty owners from that tax, so such a trade-off maybe valid to only a small percentage. It thus white-washes the real economic disaster underway. We believe heartedly, of course, in credits for the ederly, but believe that killing off the industry, which would invalidate those credits, is more serious.

The entire plan is bureaucratic insanity, another Dust Bowl versus the Rust Bowl war, and an attempt that I sincerely believe is a further step to nationalize the energy industry, or put it in the hands of a few giants, which could put us into further bondage to the OPEC nations.

NARO endorses fully joint plans by Oklahoma Governor George Nigh and Texas Governor Mark White to protest the tax proposal. Our members have met in Austin with Lt. Governor William Hobby, Speaker Gib Lewis, and Senator Ray Farrabee, chairman of the Senate State Affairs Committee. Okahoma NARO delegates have met with the Sooner State governor earlier to pledge support.

We voiced angry protests in the nation's capitol the day following announcement of the tax and are mobilizing our members in non-producing states for an information blitz targeted to members of Congress that historically side against sane energy legislation.

I pray this committee spare this ailing industry any further tax tampering and get on with the larger priority of promoting energy independence by affording a fair dollar for the massive risks inherent with exploring and developing our God-given natural resources.

NARO numbers over 1,300 members in Oklahoma, nearly 5,000 in 50 states nationally, with 39,000 additional associates that belong to affiliated state and regional mineral owner groups.

NARO FACT-SHEET*
ECONOMIC EFFECT OF FEDERAL TAX PROPOSALS ON PERCENTAGE DEPLETION ON ROYALTY OWNERS OF STRIPPER WELL PRODUCTION

- Loss of $112 million in royalty payments per year nationally from stripper wells alone, and $6 billion in next five years.

- Royalty income means survival for many rural Americans and widows of farmers and ranchers. Royalty receipts are used by the thousands to bolster hard-hit family ranches in the Southwest, where no price supports bolster cattle prices.

- Would cause abandonment of 9,700 stripper wells in Texas or 1 out of 12 nationally.

- In Texas would reduce severance tax payments by $9 million.

- Reduction in drilling in 1985 of $72 million.

- Loss of 92,000 jobs nationally.

- Shorten average well life by minimum of 3.75 years.

- Every $1 lost in 40¢ less spent on new leasing and drilling.

- Would vastly cut incentives for enhanced recovery, now life-blood of majority of older fields, where bulk of nation's 2.5 million royalty owners have interests.

- Would result in loss of 779,000 bbls. per day nationally.

- Would mean $120 million less for rural Texas economy, yearly and over $90 million yearly in Oklahoma (multiplier effect).

- How then, would royalty owners prefer to be taxed? Royalty receipts should be taxed as long-term capital gains like any other asset held over a year. Most state laws consider minerals as real property. When we sign a lease, we sign over 7/8ths or slightly less of all oil and gas within an area. Yet we pay as on this as if it were ordinary income, which assumes we still own all the oil and gas. Income taxes should tax income, not gross receipts from a wasting and irreplaceable asset -- which in effect has been sold.

* SOURCE: RAM GROUP, OKLA. CITY, ECONOMIC ANALYSTS FOR ENERGY. PRESENTED TO JIM STAFFORD, NARO EXEC. DIR., AT GOV. GEORGE NIGH'S ENERGY TASK FORCE MEETING ON JAN. 9, 1985, OKLA. STATE CAPITOL. OTHER ITEMS 2 AND 3 FROM NARO COMMISSIONED STUDY, AND FROM OFFICE OF CONG. WES WATKINS (D-OK).

Senator NICKLES. Thank you, Mr. Stafford, and I appreciate the testimony of all of the panelists.

Before you leave, I have a couple of questions. I might just start in reverse order.

Mr. Stafford, you mentioned that in Oklahoma we have 260,000 royalty owners?

Mr. STAFFORD. Yes, sir.

Senator NICKLES. Is that right? How many stripper wells do we have in the State?

Mr. STAFFORD. 27,000, I believe.

Senator NICKLES. I mentioned 70,000. 77,000?

Mr. STAFFORD. I think that is right.

Senator NICKLES. Do you agree with Mr. Boggs' statement that the proposal would be most punitive for the marginal or the stripper well, and that it would encourage premature abandonment of those very marginal wells?

Mr. STAFFORD. I think the statistics show about 3 years earlier, but I think that is minor when compared to what it is in eastern Oklahoma.

When the Windfall Profits Tax was passed, for instance, you know, we were throwing the flags up of abandonments, and people said that it simply wouldn't happen.

I lost two wells in east Texas immediately after that tax was passed that were marginal, and I think it had a devastating effect on the worst depressed section of Oklahoma, which is the older areas of eastern and northeastern Oklahoma.

Senator NICKLES. Would it even have more of an impact on abandonment due to the fact that we have seen prices decline substantially in the last year and a half?

Mr. STAFFORD. If you find an independent oil man that is working eastern Oklahoma, there is going to be a banker about 4 feet behind him anymore.

Senator NICKLES. In your tax examples, you mentioned the tax increase, and you always coupled that with Social Security.

Were you talking about the fact that with persons of higher incomes, half their Social Security is taxed? Is that the provision you are talking about?

Mr. STAFFORD. There are just rambling inequities in the way it happens. Certain elderly with Social Security would receive certain relief in the very, very low brackets; but in the massive middle, let us say from incomes of $10,000 to about $35,000 of royalty income plus Social Security, those are the areas where the great inequity shows. In other words, it would be an increase in those areas.

Senator NICKLES. So you went through and applied the new tax rates——

Mr. STAFFORD. Versus the old one.

Senator NICKLES [continuing].—Versus the old one.

Mr. STAFFORD. It was done with a computer model out there and it is rather extensive data. I will furnish that to you next week.

Senator NICKLES. Do you happen to have any information, or Jack, would you have any information on the number of stripper wells that have been abandoned in the state in the last year?

Mr. GRAVES. No, sir, I do not have.

Senator **Nickles**. The average production per well in Oklahoma is what, about 2.6 barrels?

Mr. **Graves**. Probably a little closer to three, three and a half barrels, depending on what particular timeframe that—it is a fluid thing. It depends on what particular time the question is asked.

Senator **Nickles**. I would be interested, Jack, if you could submit that for the record, because, again, I think a lot of people in Washington, DC, when they think of oil wells and they read about a success story somewhere, they have that vision that all oil wells are producing so many hundreds of thousands of barrels.

They do not recognize or realize that the average producing well, and the average of those stripper wells that you are talking about, would be in that two-barrel classification. And the average of all wells, I think, would be closer to a little less than three.

But I would be interested in having that for the record because I think that would help on that point.

Mr. Singer, a question. Are you a producer, an independent producer?

Mr. **Singer**. Yes, sir.

Senator **Nickles**. You made a very good point in your testimony, and I think statistics can show that independent producers have put basically all their income back into oil and gas investment, and that their amount of reinvestment has been large.

Mr. **Singer**. They have either invested directly, Senator, or caused investment. Independent producers tend to be catalysts for investment by raising money from outside their own internally generated funds and causing it to be invested; and this proposal would have absolutely catastrophic effects on the outside investment.

Senator **Nickles**. Well, looking at that, how much of a tax increase do you see in this proposal? Have you looked at it from that vantage point?

Mr. **Singer**. I am not sure I understand the question.

Senator **Nickles**. How big is the tax increase? The question I am trying to get to eventually is what percentage of a reduction in production do you think you would have?

Mr. **Singer**. Senator, I had occasion to visit with some people from the Treasury, and they are working on the assumption that the outside capital that is invested in the oil and gas industry is very small, and the assumption is based upon looking at registered oil and gas programs, which only represents a small percentage.

They do assume in their proposal that there will be no outside investment to speak of in the oil and gas industry. Based upon the fact that we believe, independents believe it represents perhaps 20, 25, 30 percent of the money that is actually put into exploration, that number alone is certainly indicative of the kind of down-turn that you would see.

I talked to a number of people, looked at my own situation, and I know that we would see the kind of reduction probably that Mr. Graves indicated, probably somewhere in the 40 to 65 percent range, irrespective of what is happening to the prices.

Just isolating the tax proposal, we would be much less inclined to continue being as active and as aggressive in the oil and gas business.

Senator NICKLES. A 40 percent reduction would be——

Mr. SINGER. At the minimum.

Senator NICKLES [continuing]. At the minimum.

Mr. Stewart, same question.

Mr. STEWART. I think that is a good——

Senator NICKLES. I have been searching for this percentage figure because I think it is important, and as I mentioned in my opening statement, we have something like what, 2,100 or 2,200 active rigs. I am trying to figure out how many active rigs we would have in a year after this proposal passed.

Are we looking at 1,800 or 1,700? I don't know.

Mr. SINGER. Senator, part of the problem in answering the question is that you do have dramatically different circumstances in different producing areas.

The question was addressed by John Miller, who is the former president of the Independent Petroleum Association of America, and he focused on the fact that in Michigan, notwithstanding a drop in crude oil prices, they are maintaining relatively high gas prices.

He was looking at something, $3-plus average gas price, and he found in his situation it would be approximately a 27 percent drop, just roughly, on a given year.

There are parts of New York where the average production is much less than 1 barrel a day. Stripper wells are all they ever have. They don't see wells that ever come in for more than 10 barrels a day there. There would probably be no drilling at all.

So that you will have a range that probably goes from 25 to 100 percent, and I imagine 40 to 60 percent narrows down your average picture, but it will depend on individual circumstances.

Senator NICKLES. Mr. Graves, in your example did you say you had in the past couple of years been drilling what, 40 wells a year?

Mr. GRAVES. Yes, sir; that is correct.

Senator NICKLES. And, if the Treasury proposal became law, you think you would drill about how many wells?

Mr. GRAVES. I think it would cut it down to at least 25 wells. Now that, as I said, provided we can see the light at the end of the tunnel, and it looks as if we do not, just run into absolute economic chaos in the country.

But based on the figures, the taxes that are proposed and the increase, it would reduce our drilling to 25 wells from 40 a year.

I would like to point out one thing. Back in the early seventies, just to show you, this one fellow said, "The trouble with being in the oil business, you have to run so fast to stay where you are."

Back in about 1971, in one particular period, I drilled 22 wells. They were all nice little wells, no barn burners, just kind of what we call bread and butter wells, which would probably end up probably 4-, 5-, 6-year payout.

At the end of the year I counted up our total daily production and we did not have any more production than we had from the sum total of leases as before we drilled the wells.

In other words, the decline, the national decline of oil and gas, especially in eastern Oklahoma, is around 10 percent a year. So, we lost in decline what we picked up by drilling the 22 wells.

So, we have to keep putting money back just to stay where we are.

Senator **Nickles**. On a national average, and maybe on an Oklahoma average, what percentage of your wells are dry wells? Mr. Stewart could you answer that question, too?

Mr. **Stewart**. Well, I think that historically you are talking about roughly 30 percent of development wells are dry, and on exploration or wildcat wells the national average is about 1 well in 10 drilled.

Senator **Nickles**. One good well out of 10?

Mr. **Stewart**. Not necessarily good; I would say just commercial, a commercial well.

Senator **Nickles**. All right. Let me turn that around. Nine out of 10 wells would be dry?

Mr. **Stewart**. Would be dry on a wildcat basis; roughly a third of your development wells.

Senator **Nickles**. Gentlemen, I appreciate your appearing before the committee. I have enjoyed working with you in the past and look forward to working with you in the future.

Thank you very much.

On our next panel, representing the larger oil companies in the State of Oklahoma, we have Joe O'Toole, representing Phillips Petroleum Co. I hope it is Phillips Petroleum and not Icahn Petroleum.

Also, we have Marvin Hambrick, executive vice president, representing Kerr-McGee; and Dr. Warren Jensen, vice president, coordination and planning, representing Continental Oil Co.

Mr. O'Toole, you can begin.

STATEMENT OF JOSEPH W. O'TOOLE, VICE PRESIDENT AND GENERAL TAX OFFICER, PHILLIPS PETROLEUM CO., BARTLESVILLE, OK

Mr. **O'Toole**. Thank you, Mr. Chairman.

My name is Joseph O'Toole. I am a vice president of Phillips Petroleum Co. located at Bartlesville, OK.

I appreciate this opportunity to testify before your committee this morning to discuss the Department of Treasury's tax reform proposals on the energy industry.

We have some very serious reservations about these proposals and believe they will drastically and negatively affect the oil and gas industry's ability to explore and produce the oil and gas and other energy resources necessary to this country.

Let me first make some general comments. We believe that the Nation's energy policy is now structured to correctly rely on the marketplace to assure adequate supplies of energy at reasonable prices.

The administration's market-oriented approach has minimized Federal control and involvement while promoting a balanced and mixed energy resource system.

I know that you and other Members of Congress vigorously support this policy.

To continue the progress made in the direction of energy policy, it is important that other Government policies affecting energy production be as consistent as possible. This is particularly true in the area of tax policy.

Generally, tax policy should not unduly discourage investment in the plant and equipment necessary to explore for and produce oil and gas. Otherwise, higher costs of capital could retard energy productivity, encourage imports and lead to greater energy dependence, thereby lessening this Nation's energy security.

Let me say here that the stated intent of the Treasury plan is to actually shift the investment away from development of domestic oil and gas reserves; and if enacted, will help accelerate this negative trend.

World petroleum reserves are disproportionately concentrated in the Middle East. Politically, these supplies cannot be assumed to be secure.

Proposals which increase our future dependence on this source of supply are clear examples of bad energy policy. The Treasury proposal is such an example.

Also, contrary to the assumption apparently contained in the Treasury proposal, the petroleum industry pays more than its fair share of taxes. Since 1980, the group of oil companies followed by the American Petroleum Institute has paid 43 percent of pretax income to the Federal Government.

By contrast, 100 nonoil industrial companies have paid 24 percent of pretax income.

The industry tax burden is even larger when we consider bonuses received by the Federal Government for exploration on the Federal-allotted Continental Shelf and royalties paid to the Government by the industry.

The Treasury's proposal would clearly increase this already excessive tax burden.

The Treasury proposal would eliminate percentage depletion. It would eliminate the election to expense intangible drilling costs, and it would eliminate investment tax credits. It would also lengthen depreciation periods.

These changes to the tax law would substantially reduce the net economic value of successful exploration. At the same time, the tax rate would be reduced, which in turn will increase the after-tax costs of unsuccessful drilling.

As a result, the risk to the capital invested by industry to find new oil and gas reserves will be greatly magnified. In short, we believe that the Treasury proposals do not recognize the unique risks and characteristics of the oil and gas industry.

We believe that future drilling and future production will fall. The effects will include increased import dependency, increased strategic vulnerability to future supply shocks, and higher long-run energy costs.

The American Petroleum Institute estimates that by 1990 oil and gas production would be reduced by 1 million barrels per day of oil equivalent. By 1995 the API believes the loss would be 1.5 million barrels per day. This is the equivalent of losing the North Slope's Prudhoe Bay production.

Over time, low cost reserves are exhausted and exploration must proceed to more costly and more risky areas. This causes replacement costs in our industry to escalate more rapidly than inflation.

The Treasury proposals do not recognize this fact.

Treating petroleum as though it is equivalent to manufactured goods or services is patently wrong, and it is distortionary and inequitable.

There are other parts of the Treasury's plan that are also troublesome. Indexation of cost recovery allowances will grossly understate the escalation of replacement costs in the petroleum industry, as well as all extractive industries.

As with any capital expenditure, the cost of replacing oil and gas reserves will tend to rise with inflation. However, unlike machinery used in steel or the auto or consumer goods industries, oil and gas reserves cannot be manufactured.

Limited and finite reserves do exist.

Capitalization of dry hole costs under the Treasury proposal is inequitable. The Treasury proposal would impose the equivalent of a ring fence like in some foreign tax systems on petroleum taxation in the United States.

This is punitive and it is inequitable and it is contrary to the treatment of losses in other U.S. industries. This would significantly increase the cost of drilling associated with appraisal and development drilling.

In summary, we believe that the current tax system of capital cost recovery for the energy industry does not need reform.

We are pleased that you have asked us to appear today, and I hope that the other members of this panel from our industry and I can impress upon you the serious consequences that the Treasury proposal would have on U.S. energy production, and on this country's long-term energy security.

I would be happy to give you any more details, Mr. Chairman, or to answer any questions.

Thank you for this opportunity.

[The prepared statement of Mr. O'Toole follows:]

Thank you Mr. Chairman. My name is Joseph W. O'Toole. I am a Vice President of the Phillips Petroleum Company located in Bartlesville, Oklahoma. As you know, Phillips is a major integrated oil and gas company involved in exploration, production, refining, transportation and marketing. Phillips is also the country's largest producer of natural gas liquids, is a major producer of chemicals and holds a large position in lignite coal reserves. I appreciate this opportunity to testify before your committee this morning concerning the impact of the Department of Treasury's tax reform proposal on the energy industry. We have serious reservations about this proposal and believe it will negatively affect our industry's ability to explore and produce the oil and gas and other energy resources necessary to this country.

I would now like to address a few issues which are directly pertinent to the petroleum industry.

- The petroleum industry pays more than its share of taxes.

Since 1980, a sample of oil companies followed by the American Petroleum Institute has paid 43% of its pretax income to the Federal government. By contrast, 100 non-oil industrial companies paid only 24% of pretax income in taxes. The industry tax burden is even larger when we consider outer continental shelf bonuses and royalties paid by the industry.

The Treasury Proposal would markedly increase the already excessive tax burden on the industry.

The current system of capital cost recovery is not in need of reform.

The present system was enacted to achieve the goals of equity, simplicity, balance and economic efficiency. It permits taxpayers to recover the before tax cost of their capital investments. It is simple. In fact, it is difficult to conceive of a simplier system of cost recovery which would continue to protect cost recovery from inflation short of expensing capital investment costs for tax purposes.

Intangible Drilling and Development Costs

1. Intangible drilling and development costs (IDCs) are those costs incurred which, in themselves, have no salvage value and are

"incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." The option to currently deduct IDCs has been part of the law for decades in recognition that the search for new oil and gas reserves entails high-risk capital intensive operations.

2. The following chart summarizes the tax treatment of IDC's:

Corporations That Are Integrated Oil Companies	Corporations That Are Independent Producers	Individuals
. Currently deduct 85% IDC's; 80% after 1984.	. Currently deduct 100% of IDC's.	. Currently deduct 100% of IDC's.
. Amortize 15% over 36 months; 20% after 1984.		. Tax preference item if currently deducted.

- May elect five-year ACRS with 10% ITC if not a limited partnership interest.
- May elect 10-year amortization.

3. TEFRA reduced the amount of current IDC deductions by 15 percent for all corporations that are integrated oil companies. The 15 percent is allowed as a deduction ratably over a 36-month period beginning with the month in which the costs are paid or incurred. These amounts are not eligible for investment tax credit. During consideration of this change the Senate Finance Committee adopted and the full Senate approved recovery of the 15 percent reduction in IDC's using the five year ACRS schedule with the

ITC. This is the same treatment afforded tangible well equipment, and intangible costs such as transportation, labor, etc. involved in the acquisition and installation of other machinery and equipment or in the drilling of water wells for irrigation. Although this rule was not adopted in the final version of TEFRA, its propriety is recognized by the election granted individuals to use five year ACRS with ITC. The Deficit Reduction Act of 1984 reduced the amount of current IDC deductions to 80 percent for corporations that are integrated oil companies. The remaining 20 percent is allowed as a deduction ratably over a 36-month period.

4. The current deduction for IDC's, both because of its positive effect on the present value of the after-tax cost of an investment

project and because of its positive contribution to current cash flow, helps to attract investment into oil and gas developments despite the high financial risk and costs. Further limitation of the right would cause withdrawal of significant amounts of capital. As a result, there would be less drilling, less oil produced, and commensurately lower tax receipts because of lower windfall profit and corporate income taxes.

The proposal is bad energy policy.

The loss of percentage depletion, the election to expense intangible drilling costs, ACRS, or ITC would reduce the net value of successful exploration. At the same time, the tax rate reduction increases the after tax cost of unsuccessful drilling. As a result, the risk element of the capital placed at risk by the industry in its efforts to explore for new reserves is increased.

Finally, the repeal of expensing for tertiary injection costs undermines incentives for enhanced recovery at a time when these activities are vital in order to maintain U.S. crude oil production and thus, a strong energy policy.

Absent this expensing, drilling and future production will fall. The effects will be increased import dependency, increased strategic vulnerability to future supply shocks, and higher long run energy costs. The API estimates that, by 1990, oil and gas production would be reduced by 1 million barrels per day of oil equivalent. By 1995 the loss would be 1.5 million barrels per day—the equivalent of losing Prudhoe Bay production.

World petroleum reserves are disproportionally concentrated in the Middle East. Politically, these supplies cannot be assumed to be secure. Proposals which increase our future dependence on this source of supply are clear examples of bad energy policy. This Treasury Proposal is such an example.

Indexation of cost recovery allowances will grossly understate the escalation of replacement costs in the petroleum industry as well as all extractive industries.

As with any capital expenditure, the cost of replacing oil and gas reserves will tend to rise with inflation. However, unlike machinery used in steel, auto, or consumer goods industries, oil and gas reserves cannot be manufactured. Finite reserves exist. Over time, low cost reserves are exhausted and exploration must proceed to more costly and more risky areas. This causes replacement costs in our industry to escalate more rapidly than inflation.

Treating petroleum exploration as though it is equivalent to manufactured goods or services is patently wrong, is distortionary and is also inequitable.

Capitalization of dry hole costs under the Treasury Proposal is inequitable.

The Treasury Proposal would impose a ring fence concept in petroleum taxation. This is contrary to the treatment of losses in other industries and is inequitable. It would significantly increase the cost and risk associated with appraisal and development drilling.

This highlights our major concerns with the Treasury proposal. I'm pleased that you have asked us to appear today and, I hope that the other members of the panel from our industry and I can impress upon you the serious consequences that this proposal has on U.S. energy production, and indeed on the long-term energy security of the United States.

In summary, we would like to emphasize that under current law, the oil industry's tax burden is among the highest in the country. New or increased taxes would further reduce returns on investment and sources of funds for an industry already hurt by declining demand and prices. Furthermore, it would discourage energy investment just as the country is making encouraging progress in the quest for energy security.

The current capital cost recovery system, relevant to most investment in the U.S., which includes Accelerated Cost Recovery and the Investment Tax Credit, is not in need of reform. It permits taxpayers to recover real, not nominal, capital costs. In addition, it achieves the goal of simplicity.

I'd be happy to give you more details on specific aspects of the proposal, or answer your questions. Thank you.

Senator **Nickles**. Thank you, Mr. O'Toole.

Our next panelist is Dr. Warren Jensen, vice president, coordination and planning, Conoco Oil Co., Ponca City.

Dr. Jensen.

STATEMENT OF DR. WARREN L. JENSEN, VICE PRESIDENT, COORDINATION AND PLANNING, CONOCO, INC., PONCA CITY, OK

Dr. **Jensen**. Mr. Chairman, I appreciate the opportunity to be here. I represent Conoco, Inc., the energy subsidiary of the Du Pont Co.

Conoco is a major participant in oil, gas, and coal development in the United States and overseas. Our history as a major employer and participant in the Oklahoma economy is a long one.

Today, many of our worldwide service operations, such as research, engineering, financial, and computer operations, and Oklahoma's largest refinery are located at Ponca City; and we have major exploration and production divisions headquartered here in Oklahoma City. Altogether, Oklahoma is home for more Conocoans, over 5,500, than any other State.

My remarks will be brief and directed at the problems we see inherent in the tax reform proposal of the staff of the U.S. Treasury. I wish to note at the outset that it is my understanding, as has been said here before, that this proposal does not represent the official position of the Reagan administration and, therefore, is rightly considered tentative in nature. It is my hope that there is substantial room for change.

Our analysis of the potential impact of the proposal indicates that it would impose significant immediate costs on our company and the energy industry while providing no credible assurance that such costs would be recovered over time.

The proposal, therefore, would lead to a significant reduction in energy development activities in the United States, resulting in a substantial increase in U.S. dependence on foreign oil over the long term, with all the vulnerabilities such dependence implies.

The provisions of the proposal that are clearly adverse to the development of U.S. energy resources include repeal of the expensing of intangible drilling costs, altered treatment of foreign tax credits, elimination of percentage depletion, repeal of the investment tax credit, the alteration of the depreciation system, and changes affecting the economics of an enhanced oil recovery.

The cumulative impact of such changes would lead to a substantial weakening of the U.S. petroleum industry at a time when market conditions have clearly made it impossible for us to absorb the consequences of ill-timed or unwarranted Government decisions without suffering great harm.

A look at project economics indicates how serious the impact can be from these changes. For instance, on one of the projects we looked at, the repeal of IDC expensing would reduce the rate of return by 26 percent.

On a refinery project, the loss of the investment tax credit would result in a 14 percent drop in the rate of return.

To be sure, the Treasury staff has sought to cushion these drastic negative changes in investment incentives by proposing a reduction in the corporate income tax to 33 percent, a 50-percent deduction of dividends and an acceleration of the phaseout of the Windfall Profit Tax.

We believe it would be very unrealistic, however, to assume that these positive changes have anywhere near the same probability of enactment as the adverse aspects of the proposal.

Moreover, even if the package were enacted as proposed, we are convinced that pressures arising from continued concern over the deficit would lead, in a very short time, to an erosion of the desirable changes, such as the reduced corporate tax rate, without any corresponding restoration of investment incentives.

Therefore, prudence dictates that we discount significantly the possibility of obtaining or retaining the positive offsets.

Enactment of the adverse provisions would, of course, have wide ranging effects. For instance, repealing the expensing of intangible drilling costs would reduce the incentive to invest in new productive capacity.

Hardest hit would be investments in onshore stripper and enhanced oil recovery operations, where intangible drilling costs account for a relatively large share of total costs. The resulting abandonment of stripper wells would result in a permanent loss of recoverable reserves, as has been noted before here.

Reduction in domestic production would increase our dependence on foreign oil and make us more vulnerable to oil supply disruptions. Our latest company projections suggest that 43 percent of the oil we use will come from foreign sources by the year 2000, even with no changes in the Tax Code. The Treasury staff approach would push the dependence above 50 percent.

Associated with the drop in investment and production would be the loss of thousands of jobs in the oil-producing States. Immediate layoffs of oil rig workers would be followed by a reduction in employment in the industries supplying goods and services to the oil industry and its employees.

State revenue from severance and other taxes would fall, forcing States such as Oklahoma to either raise tax rates or reduce services. Much of the large increase in Federal corporate tax revenue from the proposal, if enacted, would simply be a transfer of revenue from the energy-producing States to the Federal Government.

Thus, for State and local governments, the proposal can hardly be termed revenue neutral.

The adverse effects would not be limited to the energy industry. All capital-intensive industries would have new burdens. Indeed, one of the most likely outcomes of the types of changes pushed by the Treasury staff would be a weakening of most of the core industrial segments of our economy, many already experiencing severe difficulties.

This must have been readily apparent to the Treasury staff and it is difficult to understand what prompted this particular proposal under present conditions.

Mr. Chairman, in indicating Conoco's doubts as to the wisdom of a revolutionary change in the Tax Code such as this proposal, I do not wish to leave the impression that we oppose any movement way from the status quo. Change is always necessary in a dynamic economy such as our own.

But we should insist that Government-induced change has a high probability of resulting in overall improvements for the economy. The Treasury staff's proposal does not meet this requirement in Conoco's opinion.

Given what we believe is the main concern for the country, the budget deficit, it appears premature to us to expend effort presently on tax reform, especially on proposals like that of the Treasury staff which entail high immediate risks for the economy with only vague promises of future benefits.

Rather, we believe the country should concentrate on reducing the deficit, with primary emphasis given to gaining control of Federal spending.

Once we have a clearer picture of the elements required to address the deficit effectively, we will be in a much better position to determine proper approaches to tax reform. At this point, Conoco believes that the Congress should not choose many of the initiatives suggested by the Treasury staff.

Moreover, greater attention should then be given to the transition impacts of tax reform; to truly rationalizing the depreciation system, perhaps by abandoning it in favor of expensing; and to ensuring that reform encourages capital investment, productivity, employment creation, and competitiveness.

To Conoco, these are the appropriate goals of tax reform.

Thank you very much.

[The prepared statement of Dr. Jensen follows:]

COMMENTS BY CONOCO INC. - WARREN L. JENSEN
VICE PRESIDENT AND REGIONAL COORDINATOR - MIDWEST AREA

U.S. SENATE ENERGY AND NATURAL RESOURCES COMMISSION

FIELD HEARING ON THE TREASURY DEPARTMENTS PROPOSED CHANGES IN OIL AND GAS TAXATION - OKLAHOMA CITY, OKLAHOMA, FEBRUARY 15, 1985

Mr. Chairman, I appreciate the opportunity to be here. I represent Conoco Inc., the energy subsidiary of the Du Pont Company. Conoco is a major participant in oil, gas, and coal development in the United States and overseas. Our history as a major employer and participant in the Oklahoma economy is a long one.

Today, many of our worldwide service operations such as research, engineering, financial, and computer operations and Oklahoma's largest refinery are located at Ponca City, and we have major exploration and production divisions headquartered in Oklahoma City. Altogether, Oklahoma is home for more Conocoans - over 5,500 - than any other state.

My remarks will be brief and directed at the problems we see inherent in the tax reform proposal of the staff of the U.S. Treasury. I wish to note at the outset that it is my understanding that this proposal does not represent the official position of the Reagan Administration and, therefore, is rightly considered tentative in nature. It is my hope that there is substantial room for change.

Our analysis of the potential impact of the proposal indicates that it would impose significant immediate costs on our company and the energy industry while providing no credible assurance that such costs would be recovered over time. The proposal, therefore, would lead to a significant reduction in energy development activities in the United States, resulting in a substantial increase in U.S. dependence on foreign oil over the long term, with all vulnerabilities such dependence implies.

The provisions of the proposal that are clearly adverse to the development of U.S. energy resources include repeal of the expensing of intangible drilling costs; altered treatment of foreign tax credits; elimination of percentage depletion; repeal of the investment tax credit; the alteration of the depreciation system; and changes affecting the economics of enhanced oil recovery. The cumulative impact of such changes would lead to a substantial weakening of the U.S. petroleum industry at a time when market conditions have clearly made it impossible for us to absorb the consequences of ill-timed or unwarranted government decisions without suffering great harm.

A look at project economics indicates how serious the impact can be from these changes. For instance, on one of the projects we looked at, the repeal of IDC expensing would reduce the rate of return by 26 percent. On a refinery project, the loss of the investment tax credit would result in a 14 percent drop in the rate of return.

To be sure, the Treasury staff has sought to cushion these drastic negative changes in investment incentives by proposing a reduction in the corporate income tax to 33 percent a 50 percent deduction of dividends and an acceleration of the phaseout of the windfall profits tax.

We believe it would be very unrealistic to assume that these positive changes have anywhere near the same probability of enactment as the adverse aspects of the proposal. Moreover, even if the package were enacted as proposed, we are convinced that pressures arising from continued concern over the deficit would lead, in a very short time, to an erosion of the desirable changes, such as the reduced corporate tax rate, without any corresponding restoration of investment incentives. Therefore, prudence dictates that we discount significantly the possibility of obtaining or retaining the positive offsets.

Enactment of the adverse provisions would, of course, have wide ranging effects. For instance, repealing the expensing of intangible drilling costs would reduce the incentive to invest in new productive capacity. Hardest hit would be investments in onshore stripper and enhanced oil recovery operations, where intangible drilling costs account for a relatively large share of total costs. The resulting abandonment of stripper wells would result in a permanent loss of recoverable reserves.

Reduction in domestic production would increase our dependence on foreign oil and make us more vulnerable to oil supply disruptions. Our latest company projections suggest that 43 percent of the oil we use will come from foreign sources by the year 2000 even with no changes in the tax code. The Treasury staff approach would push the dependence above 50 percent.

Associated with the drop in investment and production would be the loss of thousands of jobs in the oil-producing states. Immediate layoffs of oil rig workers would be followed by a reduction in employment in industries supplying goods and services to the oil industry and its employees.

State revenue from severance and other taxes would fall, forcing states such as Oklahoma to either raise tax rates or reduce services. Much of the large increase in federal corporate tax revenue from the proposal, if enacted, would simply be a transfer of revenue from the energy-producing states to the federal government. Thus, for state and local governments the proposal can hardly be termed revenue neutral.

The adverse effects would not be limited to the energy industry. All capital-intensive industries would have new burdens. Indeed, one of the most likely outcomes of the type of changes pushed by the Treasury staff would be a weakening of most of the core industrial segments of our economy, many already experiencing severe difficulties. This must have been readily apparent to the Treasury staff and it is difficult to understand what prompted this particular proposal under present conditions.

Mr. Chairman, in indicating Conoco's doubts as to the wisdom of a revolutionary change in the tax code such as this proposal, I do not wish to leave the impression that we oppose any movement away from the status quo. Change is always necessary in a dynamic economy such as our own. But we should insist that government-induced change has a high probability of resulting in overall improvements for the economy. The Treasury staff's proposal does not meet this requirement in Conoco's opinion. It would accelerate the return to excessive dependence on foreign oil, it would further weaken already threatened core segments of our economy, and it would reduce incentives for the capital investment needed to spur increased productivity and a stronger competitive position for U.S. industry in world markets.

Given what we believe is the main concern for the country - the budget deficit - it appears premature to us to expend effort presently on tax reform, especially on proposals like that of the Treasury staff which entail high immediate risks for the economy with only vague promises of future benefits. Rather, we believe the country should concentrate on reducing the deficit, with primary emphasis given to gaining control of federal spending.

Once we have a clearer picture of the elements required to address the deficit effectively, we will be in a much better position to determine proper approaches to tax reform. At that point, Conoco believes that the Congress should not choose many of the initiatives suggested by the Treasury staff. Moreover, greater attention should then be given to the transition impacts of tax reform; to truly rationalizing the depreciation system, perhaps by abandoning it in favor of expensing; and to ensuring that reform encourages capital investment, productivity, employment creation, and competitiveness. To Conoco, these are the appropriate goals of tax reform. Thank you.

Senator NICKLES. Dr. Jensen, thank you very much for your statement.

Mr. Hambrick.

STATEMENT OF MARVIN HAMBRICK, EXECUTIVE VICE PRESIDENT, KERR-McGEE CORP., OKLAHOMA CITY, OK

Mr. HAMBRICK. My name is Marv Hambrick, and I am executive vice president and director of Kerr-McGee Corp.

The Treasury proposals are quite detrimental to the cash flow of the energy industry. We have used the Kerr-McGee forecast to estimate the change in tax liability for Kerr-McGee for the years 1986 through 1989, the first years of application of the Treasury's proposals.

The tax liability of Kerr-McGee would be increased by 90 percent, almost double on an average basis for those 4 years.

We have also taken a group of eight U.S. oil companies and computed the tax effect of the Treasury proposals by using information from the 1983 annual reports and 10-K's, as if 1983 were the first year covered by the proposals.

The total of oil and gas exploration of our sample of companies, total oil and gas exploration expenditures, was $5.4 billion in 1983. The increased taxes that these companies would pay amounts to $1.65 billion dollars. It is fair to say that is 31 percent of the exploration expenditures; the eight companies would have spent 31 percent less.

There are other surveys that have been made. The public accounting firm, Arthur Andersen arrived at a 25 percent reduction in industry expenditures if the Treasury's proposals apply to 1985, and estimated that Federal income tax payments would triple.

The Interstate Commerce Commission has issued a study which concludes that there would be a ⅓-reduction in oil and gas industry expenditures in the United States.

So, we have indeed a range of reduced exploration and development expenditures of a quarter to one-third. What would the effect be, given the timelag of a few years?

It is, as other witnesses have said, particularly Mr. Boggs, difficult to project this and exclude other factors which will affect U.S. production, such as the anticipated decline in the Prudhoe Bay Field.

Our conclusion, which we believe is relatively conservative, that in 1990 and years following, U.S. crude oil production would be reduced by 1½ billion barrels a day. This reduction would necessarily be offset by importing crude oil or refined products, increasingly refined products, primarily from OPEC countries.

The result would be an increase in the trade balance deficit in the United States, already at a record high of $123 billion for 1984. In the 1990 timeframe, and assuming a $27 price for crude oil, which is fairly conservative for that year, it would add $15 billion to the trade deficit.

As has been said by other witnesses, the Treasury proposals run contrary to the national security requirements of the United States. The favored treatment of oil and gas and mineral production has been in the Internal Revenue Code almost from the inception of taxation in the United States.

The national policy of ensuring a strong domestic energy industry has been reflected in the past by other governmental action, such as the import quotas on foreign oil prevailing through the fifties and sixties. Such policies have been considered necessary for the preservation of a secure domestic energy supply, and have generally on a bipartisan basis been supported as in the national interest.

The necessity for such a policy could not have been greater in any prior period than it is today.

Finally, others have talked about the fairness and simplicity part of the proposal. I will also mention the economic growth.

It is quite unlikely that these tax proposals, when applied to the oil and gas industry, and even when applied to industry generally in the United States, will result in economic growth.

The present administration is clearly committed to such a policy. The administration's policies have been successful in stimulating increased investment in productive facilities of a magnitude not equaled in this country for the past 25 years.

The investment tax credit was first placed in the laws in the early 1960's for the purpose of stimulating economic growth. Eliminating the investment tax credit and the depreciation policy written into law earlier in this administration will scarcely ensure the economic growth that is necessary and desired by the administration.

Continued economic growth in the United States will increase the requirement for energy in the United States and will magnify the problems created by the Treasury tax proposals and will further increase the necessity for importation of crude oil.

Thank you.

[The prepared statement of Mr. Hambrick follows:]

STATEMENT

OF

MARVIN HAMBRICK

KERR-McGEE CORPORATION

SUBMITTED TO THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

REGARDING

TREASURY TAX SIMPLIFICATION PROPOSALS

OKLAHOMA CITY, OKLAHOMA

FEBRUARY 15, 1985

THE PRESENT TAX BURDEN OF THE OIL AND GAS INDUSTRY:

The title of the Treasury Department report to the President on tax reform is called "Tax Reform for Fairness, Simplicity, and Economic Growth". This title fairly well summarizes the claims made for the Treasury Department proposals. The Treasury makes statements such as:

(a) "The Internal Revenue Code contains subsidies to particular forms of investment that distort choices in the use of the Nation's scarce capital resources."[1]

(b) "Equity and neutrality demand that all financial institutions be taxed uniformly, on all of their net income."[1]

One could be led to think, from the title and remarks in the Treasury proposals that the proposals of the Treasury would place all industries on the same overall tax rates. This result is not accomplished, however, and the actual results would require the oil industry to pay an even greater portion of its earnings in taxes.

In the face of receding demand, the taxes paid by oil companies have remained high. Total Crude Oil Windfall Profit Tax (WPT) collections in the USA increased from $10 billion in 1980 to about $26 billion in 1981 and then, with falling crude oil prices, declined to $17 billion in 1982, to $11 billion in 1983 and to approximately $10 billion in 1984. In combination with other federal and state taxes on oil output and income, the effect of the WPT has been to strip about 80 cents of each additional dollar of oil company revenue from increased oil prices due to U.S. oil price decontrol in 1981.[2]

The WPT properly should be considered a part of the oil industry's federal tax burden even though it is an excise tax. Since a similar levy is not imposed on the price of foreign oil which competes with U.S. oil, U.S. producers are unable to pass the WPT on in higher prices. Inasmuch as the WPT is imposed directly on a portion of crude oil revenues, excluding consideration of the tax would significantly distort the industry's tax burden relative to that of all other industries which are not subject to such a tax.

Combined U.S. current federal income tax and WPT liabilities incurred by 24 leading oil companies grew to $23 billion in 1981 from $14 billion in 1980, before falling back to $15 billion in 1982 and $11 billion in 1983. Because U.S. income before these taxes rose at a slower rate, the oil companies' effective U.S. federal tax rate (current federal income taxes plus the WPT divided by income before such taxes) increased from 26% in 1979 to 41% in 1980, 49% in 1981 and then declined to 43% in 1982 and 39.3% in 1983. These tax rates have been significantly higher for oil companies than for non-oil companies each year in the 1980-83 period. These data do not reflect the practice of state and local governments of taxing U.S. oil producers more heavily than other kinds of companies. In particular, these figures exclude the billions of dollars of severance taxes and property taxes on oil and gas reserves paid by U.S. oil producers. In 1983, domestic taxes incurred by 24 leading oil companies totaled $30.2 billion. This includes $10.1 billion of motor fuel and other product excise taxes and over $20 billion, including WPT, of current U.S. federal, state and local income taxes.[2]

Various studies have analyzed the impact of U.S. taxes on the incentive to invest and have concluded that major oil companies face higher prospective U.S. taxes than most other investors. In a report published by Harvard's Energy and Environmental Policy Center, in June, 1984, Robert C. Fry, Jr. found that the effective marginal tax rate, adjusted for industry-specific taxes and tax provisions, for major oil companies is 20% higher than the average marginal rates across all U.S. industry. Fry attributes this to the Windfall Profits Tax, the loss of the percentage depletion allowance for integrated oil companies, the impairment of the deduction for intangible drilling and development costs, and the state and local severance and excise tax burden of the industry. The Fry report states that any move to further reduce the proportion of exploration and development expenditures which can be expensed or to extend the Windfall Profits Tax will have a negative impact on future oil and gas development.[3]

THE INCREASED TAX EXPENSE RESULTING FROM THE TREASURY PROPOSALS:

The general explanation of the Treasury Department proposals for "Tax Reform for Fairness, Simplicity, and Economic Growth"[4] concede the increased tax burden to the energy and mining industries of the Treasury's proposals. Two quotations will illustrate as follows:

(a) "The tax law has long been used to subsidize the energy and mining industries. These subsidies lead to inefficiencies and misdirect investment capital. They would be eliminated under the Treasury Department proposals."[4] Ibid., pg. 223

(b) "By allowing investors in oil and gas ventures to base their decisions on intrinsic economics, rather than on tax benefits generated from their investments, the productivity of all investments would increase, even if a somewhat reduced percentage of investment capital is allocated to oil and gas production and more to other industries. The adverse effect which this proposal might otherwise have on the level of drilling activity will be partially offset by the reduction in corporate tax rates, the repeal of the Windfall Profit tax and the indexation of the depletable basis".[4] Ibid., pg. 233

The conclusion of the above quotations concerning the shift of investment out of energy to other investments if the Treasury proposals are passed cannot be debated. The conclusion drawn that such shift in investment would be beneficial to the country is, however, highly conjectural. It represents the reversal of a long-standing commitment in the tax law and in other regulations such as the import quotas on foreign oil during the 1950's and 1960's which have been long understood to have been in the national interest. Such policies have been necessary for the preservation of a secure domestic energy supply. The necessity for such a policy could not have been greater in any prior period than it is today.

An increased tax burden on the oil industry would reduce the return on investment and sources of funds to an industry already hurt by declining demand and prices. As a result, the capacity to find and develop new domestic oil and gas reserves would be diminished. Such a reduction would jeopardize the progress made in recent years to reduce this country's dependence on foreign oil, particularly the dependence on OPEC oil.

While demand for crude oil in the United States dropped from peak consumption in 1978 of approximately 18.8 million barrels per day to 15.3 million barrels per day in 1982, the demand for the last two years has remained constant or increased slightly. The same general pattern is true if aggregate demand of all the major industrialized countries is considered. While the business recovery in the United States and in the world is no doubt partially responsible for the stabilizing of demand for crude oil, there is also evidence that most of the benefits of conservation of energy were achieved by the end of 1982.

The ratio of thousands of BTU per dollar of U.S. gross national product which in the mid 1970's ranged from 55,000 to 60,000 was decreased by the end of 1982 to about 46,000 BTU per dollar of GNP. It has remained approximately at that level through 1983 and 1984. It is therefore dangerous to conclude that the present excess supply of crude oil and natural gas available to the United States has eliminated any future energy problems for this country. Crude oil and refined products import still account for almost one third of the United States' requirements for crude oil and refined petroleum products. Without considering the Treasury proposals it will be difficult for the industry to maintain present crude oil and natural gas liquid production into the next decade considering the decline during the last two years in expenditures for oil and gas exploration and development and the impending decline in production from the Prudhoe Bay Field in Alaska. The impact on the oil and gas industry of a substantially increased tax burden and a substantially reduced cash flow resulting from the Treasury proposals would greatly magnify the problems of maintaining the present level of production. As is pointed out later, any material decline in present levels of crude oil production is of great significance to the country, both from the standpoint of national security and the effect of such a decline on the trade balance of the United States.

The Treasury Department's Tax Reform proposals have a significant adverse impact on Kerr-McGee Corporation over the period from 1986 through 1989. The proposed corporate tax rate reduction, coupled with the dividends paid deduction is inadequate to compensate for the detrimental effects of:

1. Loss of the investment tax credit,
2. Loss of percentage depletion on hard minerals,
3. Loss of the election to expense a portion of intangible drilling costs on oil and gas and exploration and development costs on hard minerals; and
4. The repeal of ACRS to be replaced with RCRS, extending the period over which depreciable assets may be written off.

The impact of these proposals are shown below stated as a percentage increase or decrease over taxes projected for Kerr-McGee under current law for each of the years 1986 to 1989:

Tax Increases:	1986	1987	1988	1989	Totals 1986-89
Investment credit	14.4%	20.6%	44.9%	26.1%	23.7%
Percentage depletion	15.9%	24.3%	42.4%	33.1%	26.4%
IDC, exploration and development costs	55.9%	60.7%	99.4%	60.7%	65.2%
Reduction in depreciation (ACRS vs. RCRS)	4.0%	7.2%	18.2%	21.0%	11.2%
Total Increases	90.2%	112.8%	204.9%	140.9%	126.5%
Tax Decreases:					
Dividends paid deduction	-	8.9%	16.3%	12.4%	7.8%
Reduction in tax rate	-	40.6%	56.5%	48.0%	30.7%
Total Decreases	-	49.5%	72.8%	60.4%	38.5%
Net increase in tax	90.2%	63.3%	132.1%	80.5%	88.0%

In order to estimate the impact of Treasury's proposal on the energy industry, in particular the impact on oil and gas exploration and production in the U.S., eight companies, including Kerr-McGee Corporation, were selected to form a representative sample of large publicly held companies engaged in such activities. Information regarding this group of companies discussed herein, and used as the basis for the attached Exhibit A, was obtained for the year 1983 from Annual Reports and Forms 10K published by each company.

Our calculations, as summarized on Exhibit A, indicate that for the first year in which the proposal becomes effective, when the tax rate would remain at the current 46%, the tax liability of this group of companies would be increased by $1,647,682,000. These estimated tax increases reflect only the effect of the proposed repeal of immediate deduction of oil and gas intangible drilling and development costs, the proposed lengthening of depreciable lives for oil and gas production equipment, and proposed repeal of investment tax credits for all operations of this group of companies. Significant tax increases would also occur with respect to mining operations of energy companies due to the proposed repeal of immediate deduction of mine exploration and development expenses, proposed repeal of statutory depletion, and the proposed lengthening of depreciable lives which would apply to all depreciable property.

The tax increases will have a very material adverse impact on U.S. oil and gas exploration budgets. The group of companies in our representative sample invested $5,350,990,000 in acquisition and exploration of oil and gas properties in the United States in 1983. This investment in the U.S. represented 61% of the total discretionary cash of these companies. Discretionary cash for this purpose is defined as net cash flow from all operations less debt repayment and dividends paid. The decrease in discretionary cash, due to estimated tax increases, would represent a very significant portion of the U.S. exploration budget of these companies. The tax increases would represent 31% of the U.S. exploration budget for this group if 1983 were the first year under the proposal, or 25% if the lower tax rate of 33% were effective for the first year, rather than the second. When compared to total exploration and development expenditures, the tax increases would represent 18% and 15% of the 1983 budget using the first year 46% tax rate and the 33% second year tax rate, respectively.

The relationship of the estimated tax increases for the first year under the new proposal, to the tax under current law, clearly indicates the magnitude of the expected increase in tax burden on the energy industry. The tax increase for the first year the proposal would become effective, based on 1983 information for this group, would represent an increase of 89% over the actual U.S. income taxes paid by these companies. Using the lower 33% tax rate, which would be effective beginning in the second year, the 1983 tax increase would be 74%.

Conclusions in a study by the Interstate Oil Compact Commission support the conclusions derived from the information on these eight companies. The Commission concluded that Treasury's proposal would cause a one-third reduction in oil and gas industry expenditures in the U.S.[5]

A survey by Arthur Andersen & Co. (Exhibit B) with assistance of industry associations of a very substantial majority of all oil and gas companies concerning the Treasury Department's tax proposal was taken last December. The major findings of the survey were as follows:

(a) Exploration and development expenditures are expected to rise 14% this year to $6.7 billion from $5.9 billion.

(b) If the Treasury's proposal were enacted, there would be a significant decline in their anticipated expenditures. The total would be an estimated $5.0 billion or 25% below the $6.7 billion expected above. Expenditures funded by outside investors would decline by 50%.

(c) It is estimated that federal income tax payments would triple.

THE EFFECT OF THE TREASURY PROPOSALS:

The study prepared by projecting Kerr-McGee's results from the Treasury's tax proposal, the study of a combination of 8 petroleum companies representative of the oil industry, the study by Arthur

Andersen & Co., and the numbers accumulated by the Interstate Oil Compact Commission all tend to indicate that the Treasury's proposals would increase taxes on the oil industry a minimum of 100% to a maximum of 200% over the taxes that would otherwise be paid. These studies also reflect that the estimated decrease in cash flow caused by the increased income tax expense would cause the oil and gas exploration and development expenditures of the oil industry to decline somewhere between 25% and 33%. A decline in exploration and development expenditures of this magnitude will cause a similar decline in the amount of oil and gas produced in the U.S. The decline in production would be offset by imported crude oil, primarily from OPEC countries. The result is an increase in the trade balance deficit already at an historic high of $125 billion for 1984.

Imports by 1988-90 could account for more than half of our total domestic petroleum consumption. Assuming a 1½% growth in petroleum demand and using $27 per barrel for the price of oil, foreign imports could cost the U.S. $95 billion annually by 1988-90 compared to $55 billion in 1984. See Exhibit C attached for past imports and effect on trade balances.

The Treasury proposals with respect to the oil and gas industry run counter to broader considerations than the effect on the trade balance deficit. The need for a secure domestic souce of energy should prevail without question over the reasons advanced for the Treasury proposals of "fairness and simplicity".

In addition, the present administration is committed to a policy of growth in the economy and increased business investment in modernized plant. Such policies have been successful in stimulating increased investment in productive facilities of a magnitude not equalled in this country in the past 25 years. The success of this policy and its success in the future will increase the requirement for energy in the United States and magnify the problem created by the Treasury proposals and the resulting decline in oil and gas production.

FOOTNOTES

1. Tax Reform For Fairness, Simplicity and Economic Growth - The Treasury Department Report to the President - Summary of Proposals.

2. Statement of The American Petroleum Institute, submitted to the Committee on Finance. United States Senate regarding hearings on major tax reform options. Washington, D.C., August 7 and 9, 1984.

3. Fry, Robert C., Jr., Industry-Specific Taxes and Effective Tax Rates, John F. Kennedy School of Government, Report No. E-84-05, Harvard University, Cambridge, Massachusetts, June, 1984.

4. Tax Reform for Fairness, Simplicity and Economic Growth - Volume 2, General Explanation of the Treasury Department Proposals.

5. Press release at 2:30 p.m. on January 14, 1985 in Oklahoma City, Oklahoma by Interstate Oil Compact Commission. Findings of study commissioned by the Governors of Oklahoma and Texas.

EXHIBIT A

Selected Oil Companies
Estimated Effects of Various Proposed Tax Law Changes
Assuming Changes Were Effective in 1983
(Thousands of Dollars)

	Decrease in Tax Deductions or Credits
Major Changes Affecting Large Oil Companies:	
(1) Repeal of immediate deduction of oil and gas intangible drilling and development costs.	$ 2,092,359
(2) Depreciation of oil and gas production equipment over 15 years versus 5 years.	$ 91,410
(3) Repeal of investment tax credits	$ 643,148

Increase in Federal Income Tax:	Tax at Proposed Rate of 33%	Tax at Current Rate of 46%
Due to deferral of IDC deductions	$ 690,478	$ 962,485
Due to longer depreciable lives	30,165	42,049
Due to repeal of investment tax credit	643,148	643,148
Total increase in Federal income tax	$ 1,363,791	$ 1,647,682
Expenditures by above companies for:		
Oil and gas exploration activities	$ 5,350,990	$ 5,350,990
Oil and gas exploration and development activities	$ 9,103,276	$ 9,103,276
Total tax increase expressed as percentage of:		
Oil and gas exploration activities	25%	31%
Oil and gas exploration and development activities	15%	18%

Scope:

The information in this schedule represents combined totals for the following companies for the year 1983: Atlantic Richfield Company, Kerr-McGee Corporation, Murphy Oil Corporation, Pennzoil Company, Standard Oil Company (Indiana), Sun Company, The Standard Oil Company (Ohio), and The Superior Oil Company.

Major Assumptions:

(1) Assumed that the U.S. Treasury Department proposal were first effective in 1983. Tax calculation was made both as if reduced tax rate of 33% were not effective until in second year, as proposed , and as if it were effective in first year (1983). Sufficient information was not available to estimate effects on operations other than oil and gas exploration and production, except for investment tax credit, which applies to all operations.

(2) Assumed that Kerr-McGee Corporation's depreciable equipment included in totals of exploration expenditures and development expenditures are representative of the ratios of depreciable equipment included in those expenditures of other companies in the schedule.

(3) Assumed that the average per well cost of development dry holes for each company is equal to the per well average cost of exploratory dry holes on the same company.

(4) Assumed all companies currently depreciate their oil and gas production equipment under the Accelerated Cost Recovery System for U.S. income tax purposes.

(5) Assumed that oil and gas operations outside the U.S. are not conducted in U.S. corporations, and therefore not included in U.S. income tax returns.

Source:

Information in this schedule was derived, based on the above assumptions, from 1983 Annual Reports and 1983 Forms 10-K filed by each company.

EXHIBIT B

ARTHUR ANDERSEN & CO.

SUITE 1300
711 LOUISIANA
HOUSTON, TEXAS 77002
(713) 237-2323

January 4, 1985

Mr. Robert Mosbacher
Chairman
National Petroleum Council
2100 Capital National Bank Building
1300 Main Street
Houston, Texas 77002

Dear Mr. Mosbacher:

This report summarizes the results of a survey of oil and gas producers on the estimated potential impact on domestic oil and gas exploration and development of certain of the recent income tax proposals of the Department of Treasury ("Treasury"). The survey was limited to assessing the impact of Treasury's proposed changes in the deductibility of intangible drilling and development costs ("IDC"), elimination of statutory percentage depletion and the investment tax credit ("ITC") and lower tax rates. The survey was conducted at your request by Independent Petroleum Association of America, Mid-Continent Oil & Gas Association and Texas Independent Producers and Royalty Owners Association. Arthur Andersen & Co. and Vinson & Elkins assisted the associations in developing the enclosed survey questionnaire, and our firm compiled and analyzed the responses to the survey, as presented below.

Each of the three industry associations mailed the questionnaire to a portion of their respective memberships. Also, at your request, Arthur Andersen & Co. sent the questionnaire to the chief executive officers of 334 publicly owned companies that were included in our firm's publication, Oil & Gas Reserve Disclosures: Survey of 375 Public Companies, 1980-1983. In accordance with your instructions, the international integrated petroleum companies were not included in the companies surveyed, because of the complexities involved in their tax circumstances.

All respondents were requested to send completed questionnaires directly to Arthur Andersen & Co. in Houston, where the survey results were compiled. Respondents were assured that individual responses would be kept strictly confidential and would be destroyed after the results were compiled.

Summary of Major Findings

Following are the major results of the survey:

1. The individual operators and companies responding to the survey indicated plans to increase their expenditures for exploration and development over amounts expended during their most recent fiscal year, absent any adverse changes in the income tax laws. The survey revealed that the respondents planned to increase aggregate expenditures by 14% (from approximately $5.9 billion to approximately $6.7 billion), including expenditures funded by outside investors. These expenditures are substantial, representing approximately one-third of the total domestic expenditures for exploration and development made by the industry other than the 18 largest integrated petroleum companies. This planned increase in expenditures is noteworthy in view of the decline in investment during recent years. Since 1981, annual domestic exploration and development expenditures have fallen approximately 26% (over 40% for independent producers) in response to the presently depressed economic conditions within the industry.

2. If Treasury's proposals were enacted, the respondents indicated that there would be a significant decline in their expenditures from amounts otherwise anticipated. They reported that total expenditures would be approximately $5.0 billion or 25% less than anticipated expenditures if the proposals were not enacted. Expenditures funded directly by independent operators and companies would approximate $4.4 billion, 21% less than anticipated expenditures; and expenditures funded by outside investors would approximate $.55 billion, 50% less than anticipated expenditures.

3. The respondents estimated that their own federal income tax payments would triple as a result of Treasury's proposed changes in the deductibility of IDC, elimination of statutory percentage depletion and ITC, and lower tax rates. The aggregate income taxes due would be substantially mitigated for some respondents in the initial years because of the

impact of carryforwards of prior years' tax losses and unused credits, which have accumulated under existing tax law. Without the benefit of these carryforward losses and credits, the tax liabilities of some respondents would be significantly higher. Individual operators, companies and investors would be affected differently depending on their own particular circumstances.

Description of the Survey

The survey questionnaire is divided into three sections, which provide for information regarding:

1. The level of the respondent's expenditures for oil and gas exploration and development during its most recent fiscal year, segregated between expenditures funded by the respondent and those funded by outside investors.
2. Information regarding the pro forma effects on the respondent's federal income tax liability of the Treasury's proposals having the most significant impact on domestic oil and gas producers, *i.e.*, the change in IDC deductibility, the loss of statutory percentage depletion and ITC and the lower tax rates.
3. The respondent's estimate of anticipated future exploration and development expenditures under two scenarios: (a) no changes from the present income tax laws affecting oil and gas activities and (b) enactment of the Treasury's proposals.

You indicated that Secretary of Energy Hodel requested immediate information on the expected consequences of enactment of the Treasury's proposals. Because of the urgency of this request, the questionnaire was designed to enable rapid response and compilation. Consequently, it does not fully cover all implications of the broad-reaching changes in taxation proposed by Treasury. For example, the proposed changes in the depreciation deduction for investments in equipment and in the taxation of partnerships were not specifically addressed in the questionnaire. Also, because of the manner of selecting participants included in the survey, the responses may not constitute a statistically valid sample of the overall effect of the Treasury's proposals on the industry.

Responses to the Survey Questionnaire

The survey responses have been summarized into two basic groups:

1. "Producer-funded" information reflects responses from the 170 respondents who provided the following data for expenditures funded directly by the respondents rather than by outside investors:

   a. Exploration and development expenditures for the most recent fiscal year.

   b. Estimated expenditures for the next year assuming the proposals are not enacted.

   c. Estimated expenditures for the next year assuming the proposals are enacted.

   By summarizing data from the respondents who answered all three categories, the estimated change in expenditures related to the tax proposals was identified.

2. "Investor-funded" information contains responses from the 99 respondents who provided data listed above for expenditures that were funded by outside investors. Again, all three items were needed to isolate the effect of the tax proposals on estimated investor expenditures for the next year.

The following summarizes the aggregated results for these two sources of funding for oil and gas exploration and development expenditures.

Producer-Funded Expenditures

Expenditures reported by the 170 respondents in this group totaled $4.8 billion for the most recent fiscal year. Of this amount, $2.6 billion, or 54%, were reported as being currently deductible for federal income tax purposes.

The 170 respondents estimate that if the tax proposals are not enacted, their exploration and development expenditures during their next fiscal year would approximate $5.6 billion, or a 17% increase over the $4.8 billion expended during the most recent year. Assuming the proposals are enacted, the respondents estimate their expenditures would be approximately

$4.4 billion, representing a 21% drop from the expenditures estimated assuming the proposals are not enacted.

Investor-Funded Expenditures

Expenditures on behalf of outside investors for the 99 respondents in this group totaled $1.1 billion for the most recent fiscal year. Of that amount, $.8 billion or 73% provided current deductions for federal income tax purposes.

The 99 respondents estimate that if the tax proposals are not enacted, total exploration and development funds provided by outside investors would approximate the amount provided in their most recent fiscal year, $1.1 billion. Assuming the proposals are enacted, the respondents expect expenditures on behalf of outside investors would be approximately $.55 billion, representing a 50% drop from the $1.1 billion estimated assuming the proposals are not enacted.

Investor-funded expenditures come from different sources, some of which would be much more sensitive to changes in tax law than others. For example, institutional investors and other oil and gas companies would usually not be as influenced by income tax considerations as would individuals who invest in oil and gas activities. A number of the respondents who rely on individuals as their source of funds indicated that virtually all outside investor funds would be lost if the Treasury's proposals were enacted.

. . . .

We would be happy to respond to any questions about the survey or the results described. Please contact Richard Adkerson in our Houston office at (713) 237-2323.

Very truly yours,

Arthur Andersen + Co.

EXHIBIT C

TOTAL U.S. IMPORTS OF PETROLEUM AND PETROLEUM PRODUCTION
(Thousands of barrels)

	IMPORTS						DOMESTIC PRODUCTION		
Year	Crude Oil	Unfinished Oils	Plant Condensate	Refined Products	Total All Imports	Refined Products As A % of Imports	Crude Oil and Condensate	Natural Gas Liquids	Total
1972	811,135	45,705	31,428	847,046	1,735,314	49%	3,455,368	638,216	4,093,584
1973	1,183,996	50,161	39,344	1,009,992	2,283,493	44	3,360,903	634,423	3,995,326
1974	1,269,155	44,228	32,364	885,200	2,230,947	40	3,202,585	616,098	3,818,683
1975	1,498,181	12,985	26,972	672,197	2,210,335	30	3,056,779	595,958	3,652,737
1976	1,935,012	11,735	24,408	705,256	2,676,411	26	2,976,180	587,045	3,563,225
1977	2,414,327(3)	11,239	15,003	774,077	3,214,646	24	3,009,265	590,455	3,599,720
1978	2,319,826(3)	9,913	6,017	716,889	3,052,645	23	3,178,216	572,086	3,750,302
1979	2,379,541(3)	21,372	4,729	680,825	3,086,487	22	3,121,310	578,023	3,699,333
1980	1,926,162(3)	20,015	3,781	598,745	2,528,703	24	3,146,365	575,787	3,722,152
1981	1,604,703(3)	40,793	3,658	583,716	2,188,419	27	3,128,624	587,119	3,715,743
1982	1,273,214(3)	63,657	2,292	593,144	1,866,358	32	3,156,715	565,876	3,722,591
1983	1,215,225(3)	85,580	2,355	540,584	1,843,744	29	3,170,999	568,926	3,739,925
1984	1,246,230(3)		723,948*		1,970,178		3,224,826	601,704	3,826,530

(3) Includes SPR crude oil imports--1977-7,540; 1978-58,798; 1979-23,434; 1980-16,067; 1981-93,298; 1982-60,193; 1983-85,285; 1984-71,736.

* Total unfinished oils, plant condensate and refined products. Breakdown is not available. Should be available about February 25.

SOURCE: U.S. Energy Information Administration, Annual Petroleum Statement.
1981-1983--U.S. Energy Information Administration, Petroleum Supply Annual.

EXHIBIT C

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Year	Merchandise Exports (billions)	Merchandise Imports (billions)	Merchandise Trade Balance (billions)	Petroleum Imports * Barrels per day (000)	Petroleum Imports (billions)	Petroleum Imports as a % of Merchandise Imports
1972	$ 49.4	$ 55.8	$ -6.4	4,741	$ 4.3	7.7%
1973	71.4	70.5	.9	6,256	7.6	10.8
1974	98.3	103.8	-5.5	6,112	24.3	23.4
1975	107.1	98.2	8.9	6,056	24.8	25.3
1976	114.7	124.2	-9.5	7,313	31.8	25.6
1977	120.8	151.9	-31.1	8,787	41.5	27.3
1978	142.1	176.0	-33.9	8,202	39.1	22.2
1979	184.5	212.0	-27.5	8,389	56.0	26.4
1980	224.2	249.8	-25.6	6,865	73.8	29.5
1981	237.0	265.1	-28.1	5,740	75.8	28.6
1982	211.2	247.6	-36.4	4,948	59.6	24.1
1983	200.3	261.3	-61.0	4,817	52.6	20.1
1984	220.3	328.0	-107.7	5,187	55.1	16.8

*Excludes strategic petroleum reserve imports.

Senator NICKLES. Thank you very much for your comments.

Mr. Hambrick, I have a question.

You mentioned that your net increase in tax for 1986, would be 90 percent?

Mr. HAMBRICK. Yes.

Senator NICKLES. So, your tax liability would almost double?

Mr. HAMBRICK. Almost double.

Senator NICKLES. How much tax—Kerr-McGee being a public company, I don't think you would mind telling me—how much tax are you estimating to pay in 1986?

Some people think oil companies do not pay any tax.

Mr. HAMBRICK. Well, rather than use numbers for 1986, since we do not release the forecasts, I will say that for 1983, had these proposals been in effect, our taxes would have been increased $35 million; and the number for each of the years, 1986 through 1989, is substantially higher than that.

It would be a number approaching a couple of hundred million dollars for the 4 years.

Senator NICKLES. So, in 1983 Kerr-McGee paid how much in taxes?

Mr. HAMBRICK. About $35 million.

Senator NICKLES. Does that include the Windfall Profit Tax?

Mr. HAMBRICK. No, that is income tax only.

Senator NICKLES. Just strictly income tax, so if you added——

Mr. HAMBRICK. U.S. income tax.

Senator NICKLES. If you added the Windfall Profit Tax and others, because I think, again, a lot of people when they are talking about tax policy, they are looking at overhauling the entire Tax Code. I think it is not just the corporate income tax, but also look at excise taxes, and look at the Windfall Profit Tax in addition to that.

Mr. HAMBRICK. Yes.

Senator NICKLES. I look forward to going through all of our panelists' statements, and I appreciate them. I can tell that many of our panelists have done a lot of exceptional homework, and I look forward to learning as much as I can.

You mentioned that you did a study of eight oil companies based on their 1983 returns?

Mr. HAMBRICK. Yes.

Senator NICKLES. Did you find that those oil companies paid a lot of tax in 1983, or not?

Mr. HAMBRICK. Yes, all paid tax in 1983 in substantial amounts.

Senator NICKLES. And these are eight majors?

Mr. HAMBRICK. These are not Exxon and Mobile, because it was more difficult to subtract out their foreign operations. The companies we used were Atlantic-Richfield, Murphy, Pennzoil, Standard of Indiana, Standard of Ohio, Sun, Superior and Kerr-McGee.

Senator NICKLES. And their tax liabilities would increase how much in 1983?

Mr. HAMBRICK. Their tax liabilities would have increased in 1983 by about 75 percent.

Senator NICKLES. I will ask all of our panelists—how much of a reduction in your production do you think would result because of this proposal? Do you have a guesstimate?

Mr. **Hambrick**. In Kerr-McGee's production—we used the backroad approach to get the million and a half barrels, and I did not estimate it on Kerr-McGee's production; but I do not think that we would vary far from the sample that we used.

Senator **Nickles**. The 30 percent?

Mr. **Hambrick**. Thirty percent.

Senator **Nickles**. Would it be somewhat similar for Phillips or Conoco?

Mr. **O'Toole**. We are talking about the long run, and we think over a long run, these reduced tax provisions and increased tax burden, that it will affect Phillips' long-run production.

What we have today, of course, that would go on. We are talking about new activities and they would be affected.

Senator **Nickles**. Would it also encourage premature abandonment of stripper wells?

Mr. **O'Toole**. Yes, sir; it could.

Senator **Nickles**. And declining enhanced recovery on other marginal wells or fields?

Mr. **O'Toole**. It will change the economics. As you look at enhanced recovery and the inability to expense such, it will make it more costly, so, of course, some of these will fall off, some of these projects.

Senator **Nickles**. One of the reasons why I wanted to have a panel of the majors--and all the companies represented in this panel are very vital to the economy of Oklahoma, and I think we have had a lot of representation, and rightly so, from the independent sector—some have alleged that this wouldn't affect the majors quite as badly because the majors already don't have percentage depletion.

But today I have heard a unanimous statement from the major oil companies that are represented in Oklahoma, or represented on this panel, that you think that these proposals would be quite detrimental to your companies and also to our country.

Is that correct?

Mr. **Hambrick**. Yes.

Mr. **O'Toole**. Yes.

Dr. **Jensen**. Yes. I don't think there is any doubt but what it will affect the majors significantly.

Senator **Nickles**. Well, gentlemen, I appreciate your willingness to appear hear today.

I might ask one additional question. Mr. Hambrick, this might be more in your line of expertise.

Some people have suggested one avenue of approach, or a different possibility, would be allowing a 3-year write-off on IDC's.

Do you think that would be an idea that should be pursued, in contrast to the present tax policy?

Mr. **Hambrick**. I am sure we would like to keep the deduction first, but 3 years would be far better than the proposal we now have.

Let us just assume that it would average 10 years to amortize the intangible drilling costs over the life of the property. At the completion of 10 years the amortization would about equal the immediate deduction, if you spent a level amount.

At that point any company, let us say they were spending $1 million a year, they would be $9 million behind, but by the 10th year they would be getting $1 million in amortization.

If you go to a 3-year amortization, that cycle is cut to 3 years. At the end of 3 years the company is getting a deduction of $1 million and it is only $2 million behind.

Now, that is a simplified example because for almost all of us our intangible deductions go up, and so the detriment is greater than my level example. But it would on a level amount cut the effect of this proposal, based on my 10-year average life, by 70 percent.

Others may not agree with the 10 years.

Senator NICKLES. I just threw that question out, just to get your comments on it.

Panelists, we thank you very much for your participation here today.

On our next panel, we have Dr. Bill Talley, representing the RAM Group and the IOCC study; Mr. Jack Taylor, chairman, Government relations, American Association of Petroleum Geologists; Mr. Richard Hess, executive director of Oklahomans for Energy and Jobs; and Mr. Tedrowe Coulter, chairman of the energy committee, National Association of Wheat Growers.

Dr. Talley, go ahead.

STATEMENT OF DR. WILLIAM W. TALLEY II, PH.D., RAM GROUP, LTD., OKLAHOMA CITY, OK

Dr. TALLEY. My name is William W. Talley II. I am president and chairman of RAM Group, Ltd.

My testimony today will summarize the findings of a three-part study initiated by the Interstate Oil Compact Commission to determine the economic impact on the United States and on each IOCC member State of changes in the Federal tax laws recently proposed by the Treasury Department.

The Interstate Oil Compact Commission is an organization of 30 petroleum producing States concerned with the conservation of oil and gas through waste prevention at the production level.

An IOCC task force commissioned the RAM Group, Ltd., an Oklahoma City management consulting firm, to conduct the study.

The IOCC report is divided into two parts. Part 1 presents the results of the study for an individual IOCC member State.

Part 2 presents the national findings.

Each part is divided into three sections, covering the economic impact of repealing the expensing of intangible drilling costs, removal of percentage depletion on stripper oil wells, and Federal tax proposals on enhanced oil recovery.

The study concludes that the Treasury Department's tax proposals would cause a dramatic drop in domestic oil and natural gas drilling, production, proven reserves, and enhanced oil recovery projects, thereby greatly increasing the Nation's reliance on imported oil.

Moreover, the reduced activity in the petroleum industry would have a severe economic impact, not only in oil and gas producing States, but on the entire Nation.

For example, the study forecasts that repealing the expensing of intangible drilling costs would result in the loss of more than a half a million jobs in the petroleum and other industries; would reduce annual drilling expenditures by about $11 billion; and would reduce domestic additions of oil and natural gas reserves by an equivalent of about 5.6 billion barrels over a period of 5 years.

Summary tables of the study's findings on a national basis and for Oklahoma for each of the three sections—that is, intangible drilling costs, on stripper wells, on enhanced oil recovery, are attached to my testimony.

The complete report will be presented to the U.S. Senate Committee on Energy and Natural Resources by the 1985 co-chairman of Interstate Oil Compact Commission, the Honorable George Nigh of the State of Oklahoma, and the Honorable Mark White, Governor of the State of Texas.

Basically, the findings show that the impact of the tax proposal is to rapidly accelerate tax payments to the Government that otherwise have been paid over a longer period of time.

The impacts are severe, resulting in a reduction in the number of drilling rigs on the average, we believe, nationwide of about 1,085 drilling rigs from the intangible drilling costs proposal; a reduction in the oil and gas production on the average of about 750,000 barrels a day, which when coupled with the effect on enhanced oil recovery projects and on stripper wells, we believe follows Mr. Boggs' testimony of approximately 1 million barrels a day in the near term, accelerating to larger levels, perhaps as high as 2 million barrels a day, after 4 or 5 years under the proposal.

It is important to note the economic impact is not only reflected in the loss of jobs, but it also ultimately results in loss of revenues to the State and local government, as well as a severe impact on other areas of the economy which provide food, clothing, and other services to people that are employed by the oil and gas industry.

Thank you.

[The prepared statement of Dr. Talley follows:]

United States Senate
Committee on Energy and Natural Resources
Energy Hearing
Friday, February 15, 1985

Testimony of William W. Talley II, Ph.D.

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-- repealing the expensing of intangible drilling costs;

-- removal of percentage depletion on stripper oil wells;

-- federal tax proposals on enhanced oil recovery.

The study concludes that the Treasury Department's tax proposals would cause a dramatic drop in domestic oil and natural gas drilling, production, proven reserves, and enhanced oil recovery projects, thereby greatly increasing the nation's reliance on imported oil. Moreover, the reduced activity in the petroleum industry would have a severe economic impact not only in oil and gas producing states but on the entire nation. For example, the study forecasts that repealing the expensing of intangible drilling costs would result in the loss of more than a half million jobs in the petroleum and other industries; would reduce annual drilling expenditures by more than $11.2 billion, and would reduce domestic additions of oil and natural gas reserves by the equivalent of more than 5.6 billion barrels of oil.

Summary tables of the study's findings on a national basis and for Oklahoma for each of the three sections are attached. The complete report will be presented to the United States Senate Committee on Energy and Natural Resources by the 1985 Co-Chairman of Interstate Oil Compact Commission, The Honorable George Nigh of the State of Oklahoma, and The Honorable Mark White, Governor of the State of Texas.

MASIDC

IMPACT OF FEDERAL TAX PROPOSALS OF INTANGIBLE DRILLING COSTS
1986 - 1991

AVERAGE IMPACT 1986 - 1991	NATIONALLY	OKLAHOMA	
REDUCTION IN ANNUAL DRILLING	$11,213,406,500	$1,651,368,859	Per year
REDUCTION IN JOBS	560,670	82,568	Per year
REDUCTION IN NUMBER OF WELLS DRILLED**	180,997	22,127	Wells
REDUCTION IN DRILLING RIGS	1,085	142	Per year
REDUCTION IN OIL AND GAS RESERVES ADDED**	5,607,000,000	825,728,131	Boe
REDUCTION IN OIL AND GAS PRODUCTION	757,494	111,554	Boe per day
REDUCTION IN ANNUAL OIL AND GAS REVENUES	$5,427,000,000	$799,220,005	Per year
REDUCTION IN SEVERANCE TAX PAYMENTS	$434,000,000	$56,603,870	Per year

** Wells drilled and reserves are cumulative 1986 thru 1991.
All others are averages per year.

Basis:

- 1984 average number of drilling rigs:	2,428	319
- 1984 JAS total drilling expenditures:	$25,104	$3,697
- 1983 JAS average well cost:	$371,721	$447,794
- Gross production tax rate:	8.00%	7.09%

- Industry expenditures are reduced by one-third in 1986 due to uncertainty and reduced third party funding.
- Third party funding is reduced by one-half in 1986 due to uncertainty in in tax treatment.
- After 1986 industry expenditures remain at two-thirds of 1984 levels + or - cash flow effects from forecast tax payments.
- After 1986 third party funding remains at two-thirds of 1984 levls + or - cash flow effects from forecast tax payments.
- Reserves are added at a $12.00 per barrel oil of equivalent from 1986 - 1991.
- The 1986 - 1991 average wellhead price of oil and gas combined is $19.63 per barrel of oil equivalent.
- A reduction in drilling expenditures of one million dollars results in a loss of 50 jobs (32 direct petroleum industry jobs and 18 indirect jobs).

SUMMARY OF THE IMPACT OF THE REMOVAL OF PERCENTAGE DEPLETION FOR STRIPPER WELL PROPERTIES

LOSS OF CRUDE OIL

EFFECT OF REMOVAL OF PERCENTAGE DEPLETION	NATIONALLY	OKLAHOMA
STRIPPER WELLS AS OF 1/1/1984	441,501	77,729
STRIPPER WELLS ABANDONED	36,597	6,443 Wells
OIL RESERVES LOST DUE TO PREMATURE ABANDONMENT*	849,000,000	113,481,527 Bbls.
REDUCED OIL PRODUCTION DUE TO:		
PREMATURE ABANDONMENT	78,910	15,625 BPD
DECREASED 1986 DRILLING	2,400	475 BPD
TOTAL	81,310	16,100 BPD
REDUCTION IN ANNUAL OIL AND GAS SALES	$771,630,000	$152,791,991 PER YEAR
REDUCTION IN ROYALTY PAYMENTS	$115,700,000	$22,918,799 PER YEAR
REDUCTION IN SEVERANCE TAX PAYMENTS	$61,700,000	$10,625,313 PER YEAR
REDUCTION IN 1986 DRILLING	$308,600,000	$61,116,797 PER YEAR
REDUCTION IN JOBS	70,200	13,904

* Reserves figure is cumulative. All others are first year only.

BASIS:

- Two out of every three stripper wells are operated by independents.
- Most stripper wells have zero cost basis resulting in no cost depletion being available.
- The removal of percentage depletion results in the shortening of stripper well economic life by 3.75 years.
- Stripper wells operated by independent producers generally are exempt from windfall profits taxes.
- For every one million dollars of oil and gas revenue lost, employment decreases by 91 jobs (39 direct jobs in the petroleum industry and 52 indirect jobs in other industries).
- The average wellhead crude oil price for stripper wells will be approximately $26.00 per barrel in 1986.
- Every dollar in lost oil and gas revenue results in $0.40 less spent to drill new wells.

IMPACT OF FEDERAL TAX PROPOSALS ON ENHANCED OIL RECOVERY (EOR)

	NATIONALLY	OKLAHOMA
REDUCTION IN EOR PRODUCTION	1,832	209 (MMBBLS)
REDUCTION IN ROYALTY PAYMENTS	10,351	768 (MM $)
REDUCTION IN PROPERTY AND SEVERENCE TAX PAYMENTS	2,228	435 (MM $)
REDUCTION IN STATE INCOME TAX COLLECTIONS	635	70 (MM $)
REDUCTION IN FEDERAL INCOME TAX COLLECTIONS	1,313	469 (MM $)
REDUCTION IN PAYMENTS TO THIRD PARTIES	34,174	3,629 (MM $)
REDUCTION IN EQUIPMENT PURCHASES	2,250	60 (MM $)
REDUCTION IN IDC'S FOR EOR WELLS	896	69 (MM $)

NOTE: All impacts are cumulative.

Basis:

- National Petroleum Council Enhanced Oil Recovery, June 21. 1984 Bartlesville Energy Center EOR Data Base And Economic Model State Bv State.
- Actual state by state current property and severence tax rates.
- Actual state by state income tax rates.
- Provisions of Treasury Secretary Regan's November 27, 1984 tax proposal regarding:
  - Intangible investments
  - Tertiary injectants
  - Revised ACRS depreciation
  - No tax credit
  - Modified depreciation schedules
  - Crude oil price of $30.00 per barrel
  - 10% rate of return on investment

Senator NICKLES. Thank you very much, Dr. Talley. I appreciate your comments.

Mr. Coulter.

STATEMENT OF TEDROWE COULTER, CHAIRMAN, ENERGY COMMITTEE, NATIONAL ASSOCIATION OF WHEAT GROWERS, TONKAWA, OK

Mr. COULTER. Yes. I am Tedrowe Coulter from Tonkawa, OK.

I am a farmer. I have been in the farming business all my life. Since college I have been working with the Oklahoma Wheat Growers Association and the National Association of Wheat Growers for the last 10 years.

I have been on the Energy Committee as chairman, and I want you to know that I really appreciate the opportunity to be here and discuss this with you, and Senator Nickles is not a Johnny-come-lately, in his interest in this. He has worked extensively with the National Association of Wheat Growers.

Last year he went to the National Convention at Denver and was on my committee up there. We really appreciate, Senator, the exhaustive work, study, and effort that you have put into the background and your interest in this energy.

We are very fortunate to have someone who is dedicated and is knowledgeable in this field.

Now, I am here to give maybe a little different perspective to this situation. Agriculture and energy are interrelated. We feel like we are partners in Oklahoma. A lot of farmers are in business today because they have had some oil income and been able to lease their land.

We just had testimony in Oklahoma City a few days ago, and our Senators Nickles and Boren, and Congressman English and Congressman Watkins were there, a group of about 600 farmers and businessmen and bankers from over the State. I see a banker or so on this panel.

As grave as some of these predictions have been, Senator, I feel they maybe have been subdued a little bit, because they know their bankers are around. I guarantee you, I like to have a good relationship with my banker. I like to have him know what my business is and how it is coming along.

I really think that that is the crux of this whole situation, is the banking institutions and the jeopardy that they are facing under these circumstances.

As we had bankers testifying in this meeting this past week here in Oklahoma City, they say that 13 percent of the farmers that are doing business with these banks are going to be denied credit in the next 60 days, and another 25 percent that are on the verge of this; and if these first 13 percent go under and are foreclosed on, it is going to precipitate this other 25 percent in decollateralization and their loans may be classified.

Now, it doesn't make a lot of difference to me, as being self-serving in this situation as a businessman, if my financial institution goes under, it doesn't make any difference if the farmers drag it under or the oil industry causes it to go broke.

If my banker is not there, I am not going to be able to visit with him, and he is not going to be able to do me any good.

I think it is one of the most grave situations that we face, and to think that this cannot happen, we can just recollect the two decisions that have been made by both political parties in two different administrations to give away almost 40 percent of our export business with these embargoes that we have.

You say that surely something this drastic could not happen to our economy here in this country. Well, it has happened. It has happened in the agricultural industry and it is inevitably appearing on the scene in this important energy situation.

Now, I think that it is on Mr. Reagan's part. I can denote his sincerity in wanting to decrease the deficits and thinking this is the way to do it. The oil will be drilled and it will be produced, and it will be hard, but somehow everybody will work through it, and then the farmers and oilmen are going to make it.

But I don't see it that way, and I think this testimony has indicated in all sincerity—and like I say, it might even be more moderate than it actually is. I see banks all over the State of Oklahoma going under, financial institutions. And if that happens—the Government says we are $120 million down in our funding already, right now, and it may even be worse.

Can you visualize what it would be if the oil industry is floundering and the farmers are going broke completely, how our schools and institutions and our services and our law enforcement would be continued?

Our taxes would be skyrocketed to the point that every person in this State would be affected.

Now, there are some people with maybe curly hair and Bostonian accents and people with gavels in their hands on both sides of both parties up there that might see some advantage to this politically, and sometimes you might want to look for political expediency and work backwards from that.

They can look with an idea like this, that it would help their constituency and maybe help perpetrate them in office and then can look for justifications for it. I think some of these justifications are shallow and if there would be any advantage, it would be very short-lived.

If this money could be taken from the oil industry back there and used in areas where there is no oil revenues—in other words, if the bus is riding a little rough, Senator, it might help to let most of the air out of the tires, but you can't run tires flat. They are going to blow out, and when it does, the bus may upset and kill everybody on it.

So, I think we need to think about everybody on the bus and think about this country as a whole, and I don't think any fears or grave insinuations that have been reflected here today are not warranted. I really think it is very serious.

We have got 16 States in the National Association of Wheat Growers that we are working with, and a lot of these people don't have—they are not knowledgeable about it.

We certainly appreciate what the Senator has done to educate them, and these people in these various States have a lot of influence and have close relationships with their Congressmen and Senators, and I assure you that we are going to be working diligently and forthwith to get them to talk to their Senators and Congressmen on this issue.

Thank you.

Senator **Nickles**. Thank you very much. We appreciate your comments.

The next panelist is Mr. Jack Taylor, who is chairman of Government relations with the American Association of Petroleum Geologists.

STATEMENT OF JOHN A. TAYLOR, CHAIRMAN, GOVERNMENT RELATIONS, AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS, OKLAHOMA CITY, OK

Mr. **Taylor**. Thank you, Mr. Chairman.

Let me just remark, as far as qualifications to speak here. I have been in the oil and gas business since 1946, a registered geologist and engineer, and with Mobil Oil Corp. for 18 years, the first part of that; head of my own independent oil company for 18 years; and for the past year I am vice president of exploration and land for Plains Resources, an independent company.

I have been a past officer of the AAPG, which has been in existence since 1916, headquartered in Tulsa, and I am currently its chairman of Government relations.

I am very happy to be here to speak to this matter. Like others, I have been in Washington and elsewhere, trying to see what we can do about this matter, which we appreciate your efforts to address it.

You know, the drilling of a well actually is not the same as building an office building, that when erected can be defined, touched and seen, and thus, the entire cost is kept alive and recovered tax free through depreciation. We all know this.

The petroleum industry, on the other hand, drills a hole in the ground that has no value. We don't even own the land on which we drill the well. We just lease it for that purpose. We establish a capital asset only when we find oil or gas in the ground with that hole, as part of a high-risk operation.

The capital asset of oil and gas we establish is a depleting asset, as has been clearly said here today. We need to find more oil and gas. We need to offset the depletion with a monetary return which we can reinvest to find more oil and gas.

The industry has a good record in reinvestment of earnings. The independent sector reinvests approximately 108 percent of its earnings. In other words, all that it makes, plus 8 percent more it can raise or borrow.

The major company sector reinvests the major share of its earnings in exploration and development. We have had the avenue to accomplish that through percentage depletion and the IDC application.

This principle was very well established early this century after enactment of the income tax law, after long testimony in the early twenties between the U.S. Treasury Department and the Congress, and each had no question about industry needing this.

It was finally settled on a compromise of 27½ percent. I think Treasury wanted 37 percent and the Congress wanted 22, something like that, and they averaged it out.

No question about its applicability. It has been with us now, what, 50 years, approximately, and now has been reduced and available only to independents at 15 percent.

The Treasury Deaprtment proposal of capitalizing a dry hole until a lease is totally condemned demonstrates an unbelievable ignorance of the business.

For instance, there are large leased tracts that are drilled for many years that result in dry holes and producers, or only dry holes that may never uncapitalize, so to speak, in a lifetime; not to mention a very common occurrence of condemnation only to partial depths.

We have never asked for handouts, but only the right of representative Government and for the marketplace to be allowed to work and for a reasonable incentive to balance the high risks we take.

We have directed the Federal Government's attention to the strategic value of oil and how increasing—and imports are again increasing, compromise that position by their effect on balance of payments and the costs of defending the sealanes and overseas bases to ward and guard those sources.

That is why we are so especially objecting, so especially confounded and discouraged by the Treasury Department's so-called tax reform proposals.

The oil industry already pays more than its share of taxes. As a matter of fact, according to a 1983 study by the Congressional Joint Committee on Taxation, domestic income tax payments by the oil industry are 2 percentage points higher than the rate paid by all corporations.

This doesn't even take into account the crude oil Windfall Profit Tax paid by oil producers. When the WPT, as we call it, is considered, the average effective tax rate paid by 24 leading oil companies in 1980 to 1983 ranged from 39 to 49 percent, while rates paid by 100 leading U.S. nonoil companies was only 23 to 25 percent, by Congress' own study.

A recent Citibank study done for the period 1968 to 1982 indicated oil industry's median rate on equity was 14.1 percent compared with 14.9 percent for total manufacturing. And certainly, these proposals will greatly blight that.

I would like to speak just a moment on a matter concerning the Persian Gulf area, which we have a large investment in military bases and sealane investment.

A recent study done and testimony before a Senate Committee indicated our cost of maintaining that part applicable only to the Persian Gulf sector and to protect the oil supply there was running about $47 billion a year.

Our balance of payments deficit coming in from oil imports runs about $50 billion a year. So, right there is $100 billion per year that we are expending essentially to protect ourselves and to take care of imports coming in.

If these proposals go into effect, and as we believe will happen, a decrease in exploration, we certainly can see an increase in that tribute we are going to be obliged to pay to the OPEC area; and furthermore, even more demands on a military posture against that part of the world.

I might note that there is a very interesting statement in the Treasury proposal, Mr. Chairman. I would like to read it for just a moment, which Treasury has stated that:

"The strategic aspect of oil is of no concern in this proposal."

I think that they are seriously flawed in that, plus the fact they have stated in the proposal, I will quote:

"Allowing IDC to be expensed also promotes an excessive reliance upon drilling, and an inadequate utilization of seismic and other more technological advanced methods of exploration."

I am authorized by the 43,000-member AAPG organization to point out that since—and especially by a recent study done by the J.D. Herrod organization, that the barrels of oil found per exploratory foot drilled in the U.S. since 1948 declined in 1948 of about 25 barrels per foot to 1965 of approximately 18 barrels per foot.

Since that time it has remained approximately flat, varied from year to year.

Now, it certainly indicates we are doing a pretty good job in utilizing our own technology in finding oil and gas without the Treasury presuming to tell us how to use those tools to find it. So, I really believe that if they will let us go about our job and retain what we believe is a fair and reasonable incentive to do that, we will keep on doing the job of finding the oil and gas in this country that we must find to keep our economy viable and guard our strategic reserves.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Taylor follows:]

Testimony
of
John A. Taylor
to the
U.S. Senate Energy and Natural Resource Committee
February 15, 1985

Thank you for the opportunity to be here today Mr. Chairman. I am here in the dual role of representing the 43,000 member American Association of Petroleum Geologists (AAPG), headquartered in Tulsa since 1917, as a past officer and currently Chairman of its Government Affairs ~~Relations~~ Committee; and as a geologist and engineer who has been involved in the petroleum business since 1946. The first 18 years was principally with Mobil Oil Corp., the next 18 as an independent operator, and the past year as Vice President of Exploration for Plains Resources Inc., based in Oklahoma City, which operates 140 wells mostly in Oklahoma and has interests in a great many more.

Others here today will present economic projections of how much industry will be blighted by the impact of the Treasury Department's proposal. Most particularly, I refer to the findings from the studies done by the Interstate Oil Compact Commission (IOCC) these past two months. They predict a rapidly unraveling industry which has already jerked in the reins, halted or radically slowed its investment principally in response to the effects of the Treasury proposals. I will dwell instead on the (1) heavy burden of taxation already borne by the petroleum industry, (2) the nations's strategic concerns on oil, (3) and the viability of exploration in this country and a measure of its success.

I remember very well an earlier important study prepared in 1964 in response to a request from Secretary of Interior Udall to the IOCC, of which I was a member of the small task force that originated that report when the efficiency of transportation of oil and gas by industry was questioned. More recently the AAPG, in response to a request by Secretary of the Department of Energy, Mr. Hodel, submitted a report and recommendations for that Department's use in preparing the National Energy Policy Plan V (NEPP V). This report was prepared by the Government Affair's Committee of the AAPG, of which I am Chairman, approved by our Executive Committee and President, and submitted November of last year. A copy is attached for your reference.

Recent announcements from the Treasury Department concerning certain tax policies affecting the petroleum industry have created marked indecision on how to proceed and has arrested much of the investment in further activity, especially in exploration drilling.

The drilling of a well is not the same as constructing an office building that when erected can be defined, touched and seen, and thus the entire cost is capitalized and recovered tax free through depreciation. The petroleum industry, on the other hand, drills a hole in the ground that has no value (we do not even own the land on which it is drilled - we just lease it for the purpose).

The expensing of intangible drilling costs(IDC's) is just as valid as the annual cost of "ordinary and necessary" expenses which may be charged off the year it occurred, just like most other businesses. We do not construct an edifice when we drill a hole. Only the equipment we place on it and the pipe we put in it has equipment or capital value. We recover that equipment cost tax free through depreciation.

We establish a capital asset only when we find oil or gas in the ground with that hole, as part of a high risk operation. The capital asset of oil and gas we establish is a depleting asset, and we need to offset that depletion with a monetary return which we can re-invest to find more oil and gas. Industry has a good record in re-investment of earnings. The independent sector re-invests approximately 108% of its earnings in drilling and the major companies re-invest the major share of their earnings in similar activity, being 80% and 66%, in 1982 and 1983, respectively, according to figures from the "Chase Manhattan Major Company Group". We have had an avenue to greatly assist that re-direction of earnings, through percentage depletion as an option to cost depletion. This principle was very well established early this century after enactment of the income tax law. After long testimony in the early 1920's between the U.S. Treasury Department and the Congress, it was set at 27.5% but now reduced and available only to independents at 15%. Encouragement for further advance in enhanced recovery rests greatly on percentage and cost depletion as well as its vital underpinning to exploration and field development operations.

The major oil corporations are able to invest large amounts of capital in a given area, such as the offshore, or along the Rocky Mountain overthrust zone, for instance, although independents are active in both, especially the latter. The independents cover much of the rest of the country in oil and gas search. They both need the continuance of IDC expensing, depletion allowance, and the investment tax credit procedure; and both, working together have provided the attack needed for reserve additions in this nation.

The Treasury Department's proposal of capitalizing dry holes until a lease is condemned demonstrates an unbelievable ignorance of the business. For instance, there are large lease tracts that are drilled for many years that result in a mixture of dry holes and producers, or only dry holes, that may never recover the total investment in a lifetime, nor fully prove or condemn a lease, not to mention the very common occurance of condemnation only to partial depths. I know of one lease in Duval County, Texas, that my old company, Mobil, has drilled hundreds of holes on since the 1920's and it is still busy being drilled. There are separate fields and many dry holes. Why should the dry holes be penalized just because they are all on one lease with the producers?

We have never asked for handouts but only the right for the market place to be allowed to work, and for a reasonable incentive to balance the high risks we take. Furthermore, we have directed the Federal Government's attention to the strategic concerns on oil, and how the again increasing imports compromise that position by their effect on balance of payments and the cost of defending the sea lanes and overseas bases to guard those sources. That is why we are so especially confounded and discouraged by the Treasury Department's so called tax reform proposals. The oil industry already pays more than its share of taxes.

According to a 1983 study by the Congressional Joint Committee on Taxation, domestic income tax payments by the oil industry are two percentage points higher than the rate paid by all corporations; this did not even take into account the Crude Oil Windfall Profit Tax (WPT) paid by oil producers. When the WPT is considered, the average effective federal tax rate paid by the 24 leading oil companies in 1980 through 1983 ranged from 39 to 49 percent, while rates paid by the 100 leading U.S. non-oil companies were only 23 to 25 percent, according to a recent analysis made by the American Petroleum Institute.

A recent Citibank study done for the period 1968-1982 indicated that the oil industry's median return on equity was 14.1 percent compared with 14.9 percent for total manufacturing The various states are again seeking additional taxes from the petroleum industry through increased severance taxes and ad valorem levies.

The economics and strategic interests of the nation would be better served by permitting the oil companies to recycle their earnings into the expanded exploration for needed oil and gas rather than siphoning off increasing amounts of the residue by steadily mounting taxation. We believe that the oil industry is paying more than its fair share.

Let us now address some strategic concerns. Treasury has stated that the strategic position on oil and gas supply in this nation is no longer of concern and was not considered in their proposal. We are agast at that position inasmuch as virtually every other department of the U.S. Government considers it important, indeed even critical to this nation's welfare. The oil of the Persian Gulf is cheaply produced. But, these costs of production are only the base of a pyramid, which includes price setting by OPEC, potential embargoes for political and strategic purposes, the interdiction of supplies by warring regional countries such as Iran and Iraq, and the task of defending the oil, at its source and along its extensive and complex land and sea routes, against military predators and hostile regimes.

The very fact that we have a Strategic Petroleum Reserve (S.P.R.) now filling in salt domes on the Gulf Coast implies that someone in the federal government is concerned about it. Have they all been asleep in Treasury, or just don't read the newspapers or responsible reports?

Our allies' dependence on oil from this region is far more abject than ours. In fact, most of ours no longer comes from the Persian Gulf or North Africa. If the Soviets were to control this region, they could subordinate Europe. Local countries could become dominated by either Marxist or extremist revolutionaries. Because of our usual self-restraint or because of a competing major power-military support-they could threaten to deprive the West, exact concessions, require tribute, or bring about financial and industrial collapse. Western Europe and Japan would then become liabilities of the United States, rather than assets.

I know we all agree that for our Atlantic Alliance and NATO partners' benefit, at least, that we must not transform ourselves from Teddy Roosevelt's dictum of speaking softly and carrying a big stick to speaking stickly and carrying a big soft; and from there, on to disaster. If we do not guard the bastion of this nation with a viable oil policy, we will be forced to speak stickly and carry a big soft. We can not afford to do anything else--unless we invest even more in a Middle East military and naval presence. It appears to me that Treasury had better come down from its ivory tower and communicate with other departments of government and especially the Pentagon.

We had a taste of near disaster in World War II. How soon we forget. The Germans were able to sink, principally between Aruba and Charleston, oil tanker tonnage in an amount of five times the size of our present merchant fleet. The lights were out, or dimmed, on the East Coast to mask the tankers silhouette and the beaches were black with oil and wreckage. We found from German Naval records, after the War, this was done from a maximum contingent, on station over that route, of only 11 Kanoe class (very small) U-Boats out of a fleet of 200, and this existed for only a relatively short period of months. And, they were not even snorkel class subs yet. A substantially greater number were occupied in traveling to and returning from this Theatre and remained on station until expending their torpedos. What do we think when we now have a world class enemy who now has some ~~600~~ 350 submarines and in which over ~~half~~ one third are nuclear types and can stay submerged for weeks on end on station. They will stop or greatly reduce the tanker traffic into our Gulf ports, interdict supply through the Indian Ocean where they already have a presence, interrupt oil supply out of Indonesia to our west coast and lay off the "choke points" of maritime traffic between Australia and the Malay Peninsula, Cape Horn, Cape Good Hope, Gulfs of Oman and Aden, and off the Straits of Gibraltar. Do we want to "throw the dice" on the question that "these martitime issues are no longer important, because if it is a war with that enemy, it will be over so fast that those issues will not have time to develop". I hope Treasury is not at the gambling table tossing the dice on this question. We must maintain a healthy ongoing petroleum industry in this country as a bulwark for our and our allies security.

The Center for Strategic International Studies, at Georgetown University, Washington D.C., in a comprehensive study, has estimated our cost of maintaining the additional amount of military basing and naval presence in defense of the Persian Gulf alone (not counting other supply sources such as Nigeria, Indonesia, etc.) now is in the order of $47 billion per year as cited in testamony to a House Committee on June 27, 1984. When we add in the value of imported oil, and its impact on our balance of payments deficit in the order of 50 billion dollars per year and now rising again, we can certainly see the economic and strategic importance of encouraging petroleum exploration and development in this country. Treasury has stated that the strategic aspect of oil is of no concern to them in their proposal. How much more do you think these military costs will go and our balance of payments deficit increase as our imports accelerate in response to declining production if these proposals are enacted?

The Treasury proposal is also flawed by a lack of comprehension of how the domestic exploration operation works. To wit, the statment from their proposal, "allowing IDC's to be expensed also produces an excessive reliance for drilling, and an inadequate utilization of seismic and other more technologically advanced methods of exploration". It still takes drilling to prove the existance of oil and gas. Indeed, the most expensive exploratory operation in history, associated with one test, was recently drilled at Mukluk in the Beaufort Sea off the coast of Alaska. It was based on extensive, advanced seismic structual and stratigraphic determinations and yet was unsuccessful. Important testing off of the East Coast of the United States in the Baltimore Canyon area, where prior information had indicated the potential presence of reservoir type beds by seismic information, has been unsuccessful after numerous tests.

Our improving technology in geophysics and new applications in stratigraphic geology modeling has led to numerous important discoveries in recent years. But, it still takes the drill bit to prove out our geologic and geophysical predictions. I will cite a few more examples of major field discoveries in recent years in addition to the two just mentioned.

Industry drilled 151 dry holes over a 17 year period in Alberta, Canada, into most every significant structural closure until the 152nd well found Devonian reef production in the famous Golden Spike discovery of 1947; and then a host of new fields followed once the drill bit had proved a new entrapment concept for the area. Look at Alberta now, a tremendous storehouse of oil and gas.

Over 200 wells were drilled in the North Sea before commercial production and then the flood gates opened, and it fuels the United Kingdom and even permits export of the excess. It took the drill bit to prove the concepts and to add data to formulating new, more workable concepts.

Or, in Northern Venzuela when we drilled the tops all the anticlines with no results until someone tried the south flank of one anticline. More discoveries followed rapidly.

Or, the giant Bell Creek field in Montana that took over 60 tests before it was found.

Or, the Fairway Field in East Texas that lay in and amongst hundreds of wells for 40 years until finally found by the drill bit and yet was in an area that had been covered by several generations of seismic work.

The recent Santa Maria Basin discoveries off California required the drill bit to overcome certain negative information in spite of previous seismic definition.

On the other hand, we do know how to use seismic to move ahead. Two of the really significant plays in Texas the past ten years have been the deep Vicksburg (commonly called the McAllen Ranch trend), and the deep Wilcox development southeast of El Paso, were based on deep basin sand development determinations from advanced seismic techniques.

Yes, we continue to be successful in exploration and are finding large reserves of oil, especially in the Rocky Mountain overthrust belt and off the coast of California, not to mention the total additive effect that thousands of wells continue to find across the United States. Fields of giant size, both oil and gas have been found in recent years along this overthrust belt, yet it took over 300 unsuccessful tests (some admittedly not significant tests) before the string of successes started. We are applying good technology and don't need the Treasury Department to enter the exploration business and prescribe the tools for us. For example, the authoritive J. C. Herold research and reporting service, Greenwich, Connecticut, has demonstrated that the barrels of oil discovered per exploratory foot drilled, after declining from 25 barrels in 1948 to 18 barrels in 1965 has flattened, on the average, at that figure ever since. In fact, it has been increasing somewhat. To be sure we do not inadvertently mislead we are obliged to note that the barrels of oil reserves added each year versus total drilling (exploratory plus field development) has been steadily declining; but when barrels of equivalent gas is added in, the decline is leveled considerably. But, the measure of exploratory effort cited still stands at the earlier statement. This does not sound like we have been hanging out in the woodshed while the high tech world passes us by, does it?

In conclusion, Mr. Chairman, we believe that we have been doing a good job in finding the oil and gas this country needs. We have done it well enough that, coupled with improving conservation measures, we have (1) managed to bring the supply of oil and gas up in response to demand in this nation and induce a price reduction thereby, (2) reduce imports from 50% down to 30% and thus enable us to wield a much heavier hammer in the game of oil geopolitics as we are now less a hostage to that politics, (3) improve our finding technology such that in spite of petroleum being deeper and more elusive all the time, we have continued to find it at reasonable rates and costs.

The country has a good thing going in those of us who will continue to devote high energy to the quest for petroleum if there are reasonable incentives to do so. Or, if the incentive is removed force most of us out of business, or into a caretaker status, except for those of us, in the attempt to survive, who will turn to increased foreign exploration, where the return may be better--this will not improve our nation's strategic concerns or arrest our increasing balance of trade deficit, which was $123 billion in 1984, of which petroleum imports contributed $60 billion thereto. We trust that good sense and wisdom will prevail and that we are permitted to get on with what we have been doing successfully for over 100 years and not have that arrested by an abrupt exercise of bad judgement. Continue IDC expensing, percentage and cost depletion, and the investment tax credits.

Senator NICKLES. Thank you, Mr. Taylor. We appreciate your comments.

Our next panelist is Mr. Richard Hess, executive director of Oklahomans for Energy and Jobs.

STATEMENT OF RICHARD L. HESS, EXECUTIVE DIRECTOR, OKLAHOMANS FOR ENERGY AND JOBS, OKLAHOMA CITY, OK

Mr. HESS. Thank you, Senator. My name is Richard Hess. I am the executive director of Oklahomans for Energy and Jobs.

I am also coordinator of the Oklahoma Coalition for Energy and Jobs, and as such, I, too, may be able to provide a little different approach to the issues that we are discussing here today.

Oklahomans for Energy and Jobs is a 2,000-member citizen coalition organized about 5 years ago to demonstrate that in Oklahoma a healthy energy industry is absolutely essential to a healthy economy.

In addition to our 2,000 individual members, we represent more than 50 trade and professional associations, and our membership is drawn from virtually all walks of life, including labor, agriculture, engineering, minorities, medicine, the law, academia, and others.

The Oklahoma Coalition for Energy and Jobs is a similarly organized coalition formed about 1 month ago. Today we represent more than 50 associations and several hundred companies. The coalition members represent a variety of trades and professions, ranging from real estate to banking, from education to retirees.

Total membership in these companies and associations exceeds 75,000 persons, and my purpose here today is to demonstrate that these tax proposals will not just affect the oil and gas industry. They will hurt every trade and occupation, the State and the entire Southwest.

The effect of these tax proposals on the oil and gas industry has already been documented by a study performed by the Interstate Oil Compact Commission.

We know that hundreds of thousands of jobs would be lost, royalty payments will fall, daily production will decline, State tax revenues will fall, drilling and exploration will be hurt, investment capital will dry up.

But the ripple effect on other parts of our economy will be even more damaging. Labor is concerned about these proposals because the American worker quite simply will be put out of work.

Agriculture is concerned because royalty payments will fall, and given the state of the American farmer, these payments often spell the difference between remaining in business and foreclosure.

Teachers are concerned because State tax revenues will fall and there will be even less money to finance education. Of course, this will also affect every other State employee.

Bankers are obviously concerned because these tax proposals will turn good loans into bad loans virtually overnight.

Minorities are concerned because they need an expanding economy in order to lessen their jobless rate. Often in a receding economy, and that is what we would have in Oklahoma, minorities are the first groups affected.

Today there are around 2,000 independent oil and gas companies in Oklahoma, and they help provide the fuel that keeps our economy going. Each of these companies retains attorneys, employs secretaries, uses stationery, employs geologists, engineers, and landmen. Each of these companies leases or owns office space, uses telephones, and replaces typewriter ribbons.

When these companies begin to hurt, everyone in Oklahoma hurts as well, from the car salesman to the realtor.

Two weeks ago we had an opportunity to speak with Ron Perlman, Assistant Secretary for Tax Reform at the Treasury Department. The one statement that I remember the most is that—this is a quote?

"Under any tax reform, there is bound to be a certain amount of pain. It is our desire to spread this pain as evenly and uniformly as possible."

I think it is obvious that these proposals do not do that. These proposals would devastate Oklahoma and the entire southwestern part of the country.

It seems to me the real question is should we save the domestic oil and gas industry; and it seems to me that the answer is that we must. If we do not, we are indeed more myopic than I care to believe.

Surely we learned from the oil embargoes of the 1970's that we cannot afford to be dependent on others for the energy that fuels our Nation. Energy dependence can only lead to rationing, inflation, recession, and economic blackmail.

Last year alone we spent about $50 billion on foreign oil, more than 40 percent of our trade deficit; and since the embargo of 1973, we have sent more than a half trillion American dollars overseas.

I would agree that tax reform is probably necessary, but not at the expense of a vital industry and hundreds of thousands of Americans.

Senator, I urge you to help us defeat these proposals, and I would urge everyone in this room to write the President today.

[The prepared statement of Mr. Hess follows:]

Oklahomans for ENERGY & JOBS inc.
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TESTIMONY OF RICHARD L. HESS
EXECUTIVE DIRECTOR OF OKLAHOMANS FOR ENERGY AND JOBS
BEFORE PUBLIC HEARING SPONSORED BY U.S. SENATOR DON NICKLES
ON THE TREASURY DEPARTMENT'S TAX REFORM PROPOSALS
FEBRUARY 15, 1985
STATE CAPITOL, OKLAHOMA CITY, OKLAHOMA

Richard S. Parsons, President
Director of Corporate Communications,
Kerr-McGee Corporation, Oklahoma City

Harry Birdwell, Vice President
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Michael B. Morris, Secretary
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Physics Consultant, Ripley

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Richard L. Hess, Executive Director

Titles are given for identification only; endorsement by organization listed is not implied

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The effect of these tax proposals on the oil and gas industry has already been documented by the study performed by the Interstate Oil Compact Commission. We know that hundreds of thousands of jobs will be lost; royalty payments will fall; daily production will decline; state tax revenues will fall; drilling and exploration will be hurt; and investment capital will dry up. But the ripple effect on other parts of our economy will be even more damaging.

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Two weeks ago, we had an opportunity to speak with Ron Pearlman, assistant treasury secretary for tax reform. The one statement I remember the most is, "There is a certain amount of pain involved in any tax reform. It is our desire to spread the pain as evenly and uniformly as possible." I think it is obvious that these proposals do not do that. Instead, they would devastate Oklahoma and the entire Southwest.

It seems to me that the real question is, "Should we save the domestic oil and gas industry?" The answer is--WE MUST. If we do not, we are indeed more myopic than I care to believe. Surely we learned from the oil embargos of the 1970's that we cannot afford to be dependent on others for the energy that fuels our nation.

Page Four

Energy independence can only lead to rationing, inflation, recession and economic blackmail. Last year alone we spent about $50 billion on foreign oil--more than 40 percent of our trade deficit. And, since the embargo of 1973, we have sent more than a half trillion American dollars overseas.

I agree that tax reform is probably needed, but not at the expense of a vital industry and hundreds of thousands of Americans. Senator, I would urge you to help defeat these proposals, and I would urge everyone in this room to write the President TODAY!

Senator NICKLES. Thank you very much. We appreciate your comments, Mr. Hess.

Dr. Talley, you conducted a very extensive study, and I compliment you on the amount of energy and effort in that study.

You included a very brief summation of that study in your statement, and I also thank you for that. The net estimate was a decline in drilling nationally of—I am looking for the figure.

Dr. TALLEY. $11 million.

Senator NICKLES. $11 million. How much are we spending in drilling today?

Dr. TALLEY. It is about a 35-percent reduction. We estimate that about one-third of the expenditures from the oil and gas producers, their expenditures would be reduced by about a third; and the amount of money from third-party funding, which is bank borrowing and outside investors that are not actively involved in the oil and gas industry would drop by about half, which results in an overall 35- to 40-percent reduction in expenditures.

Senator NICKLES. To do the study, you had to make some kind of assumptions on what oil prices would be. What oil price did you use?

Dr. TALLEY. We used an oil price of $26.75 held constant throughout the time period.

Senator NICKLES. $26.75?

Dr. TALLEY. Yes, sir.

Senator NICKLES. Of course, the price of oil is lower than that today.

Dr. TALLEY. Yes, sir.

Senator NICKLES. You also mentioned that in Oklahoma there would be a reduction of 82,000 jobs. Is that correct?

Dr. TALLEY. Yes, sir.

Senator NICKLES. And a reduction in the number of wells drilled of 22,000?

Dr. TALLEY. Yes, sir; that is correct.

Senator NICKLES. How many wells are we drilling today in Oklahoma?

Dr. TALLEY. Actually, for the timeframe of 6 years, the average—last year we did about 10,000 wells. The annual reduction is down by about 30 percent.

Senator NICKLES. OK. So, instead of drilling an estimated, say about 60,000 wells——

Dr. TALLEY. Would drill about 6,000 wells a year instead of 10,000.

Senator NICKLES. I appreciate your comments, and I appreciate the comments of all of you.

I want to ask Mr. Taylor a question. A lot of statements have been made and, again, very few people, I think, in Washington, DC, understand that you do not always find oil every time you poke a hole in the ground.

How many wells as far as wildcat drilling, are successful? What are the ratios?

Mr. TAYLOR. Mr. Chairman, actually, across the board, about 1 exploratory well out of 10 is successful, and of that 1, it takes about 40 of those type to find a field of significant size. That is the way it works.

If you please, I would like to just mention one thing I think is very important.

We understand through certain testimony in Treasury that a lot of their feeling about the IDC's thing, it was not fueling the proper activity because we weren't doing the kind of exploratory job we ought to be doing in this country. And the figures do not show that at all, as a matter of fact, in the numbers I quoted. And that we ought to use more seismic and technology.

I have to point out to you that the largest expense exploratory ever known today was just offshore Alaska, and it was an abject failure so far, in both using stratigraphic seismic and stratigraphic work to indicate possible hydrocarbons. It took the drill bit to find it.

The same thing has been true off the east coast of the U.S. on that drilling. It takes the drill bit in the end to find it.

Senator NICKLES. To find it, or to find that it is not there.

Mr. TAYLOR. And seismic is good, Mr. Chairman. We are using a lot more of it, but I don't think we need to be told by Treasury on how to do it.

Senator NICKLES. Gentlemen, I appreciate your comments and your participation in the hearing today.

Thank you very much.

On our next panel we have Mr. Sam Noble, who is chairman of the board, Noble Affiliates in Ardmore; and Mr. Ray Potts, president of PSEC.

I appreciate your appearance here today, and I also appreciate your willingness and past efforts to convince Secretary Regan and others of the consequences of following these proposals.

Mr. NOBLE.

STATEMENT OF SAM NOBLE, CHAIRMAN OF THE BOARD, NOBLE AFFILIATES, ARDMORE, OK

Mr. NOBLE. Thank you, Senator. Thank you for the opportunity to appear before your panel, and we also want to tell you how much we appreciate the things you are trying to do for us.

Senator NICKLES. Thank you.

Mr. NOBLE. I am Sam Noble, chairman of Noble Affiliates, which I would classify as a medium-sized, publicly-owned independent oil company.

We both explore for oil and gas, domestic and foreign, and we drill for oil and gas for other people, both domestic and foreign. These companies have been in business for more than 50 years, and I personally have been investing my own funds in the industry for approximately 35 years.

Senator, I have been through several tax reforms, none of which were to my economic benefit. This is my first simplification. I do not look forward to that.

I think it might be well to remember a little of our history and see where the industry is and how it got there, at least in my timeframe.

In the early fifties until the early seventies, world petroleum prices at the wellhead were almost constant of about $2.50 a barrel to $3.50 a barrel, depending on distance to the market and the quality of the oil, and what have you.

Also in the early fifties, you will remember the Supreme Court saw fit to regulate the wellhead price of natural gas going into interstate commerce. This fact of life, which dealt most unjustly with many producers and royalty owners, remains still with us today.

Also, constantly rising prices for goods and services used in the search for oil and gas, coupled with little change in the selling price of the product over a 20-year period, caused our industry to be very sick by 1970. Most people do not remember that.

Feeling this pinch, several of the world's largest producing countries outside of the U.S. formed a cartel, which was able to effectively raise the world oil price to unprecedented levels over 4 years.

Washington reacted with its usual wisdom. Its experts, including the President and the media, told everyone that doomsday was near, we would be out of oil and gas in 10 years.

As a consequence, Congress put price controls on the wellhead price of oil and further complicated the already regulated natural gas market by decontrolling deep gas, which created new and highly inflated prices for certain categories of this gas.

It also passed the Windfall Profits Tax, which has already taken billions of dollars from domestic producers without taxing our foreign competitors one penny.

Well, what happened? Prices continued to rise and the investment community reacted swiftly. They poured money into the industry, and the U.S. drilling count rose from about 900 in 1970 to over 4,600 in 1981.

Exploration activity outside the U.S. also exploded and reserves, both domestic and foreign, increased dramatically.

Also, predictably, as prices rose, people used less, and by the fall of 1981 both the U.S. and the world had a surplus producing capacity of both oil and gas relative to the market.

Now, what has happened since 1981?

First, the world price of crude oil has fallen from $38 to about $26 per barrel. This is after price controls were removed.

Prices for the expensive deep gas have fallen from the $8 to $9 range per MCF to $2.50 to $2.75.

Also, the gas transmission companies have reduced the volume of gas they take to levels significantly lower than what they were in 1981.

Domestic drilling rig count has declined from 4,600 in the fall of 1981 to 2,100 last week. This has dropped about 100 rigs a week for the last 7 weeks. And coincidentally, these rapid drops started right after the Treasury Department's new tax proposal was unveiled.

Today we have an industry that is in disarray. Large segments of it, particularly the oil services part, which expanded too rapidly, and many independents are already in bankruptcy or near to it.

Some sizable banks which lend to the industry have already failed, and many more are in big trouble, which brings me to the point of this whole exercise.

What does the Treasury propose for an industry already flat on its back?

Well, it proposed to reform and simplify our taxes again, and in so doing to repeal, among other things, the ability to charge off intangible drilling costs on oil wells, even those which are dry and incapable of producing; repeal the percentage method of calculating depletion, all investment tax credits, and many other things.

Congress in its wisdom created these charges against income many years ago, realizing the search for oil and gas is a very high-risk business.

In our company, historically, a little over 60 percent of all the wells that we have drilled have been dry.

How does this affect our company? Over the next 5 years, we will pay $116 million more in Federal income tax, which is an increase of 70 percent over what we would pay under the current tax law.

This reduction in cash flow will severely restrict our exploration efforts in future years, and this effect will be mirrored by the industry as a whole, majors and independents alike.

At our present costs—and finding this for our company—this represents some 11 million barrels of oil that we won't discover.

What will happen to the domestic oil and gas industry?

The independent producer, who has been responsible for discovering about 70 percent of the new domestic reserves of oil and gas, will virtually disappear in 5 to 10 years, I think.

The major oil companies and the larger independents who receive no funds from the outside will continue to explore, but will increasingly turn to foreign areas which are more profitable.

A large part of the oil service industry will disappear, as there will be no longer a need for these services.

Hundreds of thousands of jobs will be lost nationwide. I think it is estimated over 90,000 in Oklahoma, as well as the taxes therefrom.

The Treasury will indeed collect more tax from the oil industry for a couple of years, and then this tax base will rapidly begin to disappear.

As a consequence, this country will become more dependent on foreign oil and whatever that portends, in terms of the national security, balance of payments, et cetera.

In my view, the Treasury proposals as they apply to the oil industry, if they are enacted in their present form, will be a national tragedy.

Thank you.

[The prepared statement of Mr. Noble follows:]

NOBLE AFFILIATES, INC.
330 Neustadt Plaza P. O. Box 1967 Ardmore, Oklahoma 73401 405-223-1900

Sam Noble
Chairman of the Board

February 14, 1985

Honorable James C. McClure
Chairman, Committee on Energy
and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In response to your letter of February 5, concerning the Committee on Energy and Natural Resources hearing scheduled for February 15 at the State Capitol Building in Oklahoma City, following is my written statement for the record.

"I am Sam Noble and presently am the Chairman of the Board of Noble Affiliates, Inc., a medium sized independent energy company whose stock is traded on the New York Stock Exchange. I have also served for several years as Chairman and Chief Executive Officer of Samedan Oil Corporation and as a director of Noble Drilling Corporation both of which are wholly owned subsidiaries of Noble Affiliates, Inc. Samedan explores for and produces oil and gas both domestic and foreign and Noble Drilling does contract oil and gas drilling for both the major oil companies as well as for independents. Both Samedan and Noble Drilling have been in business for more than 50 years and presently employ 1,553 people. In addition to this, I have been investing my own personal funds in oil and gas exploration for 35 years.

"From the early 50's until the early 1970's, world petroleum prices at the well head remained almost constant, i.e. in the $2.50 to $3.50 per barrel range, depending on the quality of the oil, the distance from the market, etc. Also during the early 1950's, the U. S. Supreme Court saw fit to regulate the wellhead price of all natural gas going into interstate commerce. This fact of life, which has dealt most unjustly with many producers and royalty owners, remains with us today. Constantly rising prices for goods and services used in the search for oil and gas coupled with little change in the selling price of its product over a twenty-plus year period caused our industry to be very sick by 1970. Feeling this pinch, several of the world's larger producing countries outside of the U.S. formed a cartel about 11 years ago which was able to effectively raise the world price of oil to unprecedented levels over about 4 years. Washington reacted with its usual wisdom. Its experts, including the President and the media, told everyone that doomsday was near. The United States would be out of oil and gas within 10 years, etc. Congress quickly put price controls on the wellhead prices of oil, passed a fuel use act to restrict the uses of natural gas (still in effect) and further complicated the already regulated natural gas market by decontrolling the prices for deep gas which created new and highly inflated prices for these categories of gas. It also passed a 'windfall profits' tax which has already taken billions from the domestic producers without taxing our foreign competitors one cent. Well, what happened? Prices continued to rise and the investment community reacted swiftly to this incentive. Money poured into the industry. The U.S. drilling rig count rose from 900 in 1970 to over 4,600 in 1981. Exploration activity outside the U.S. also exploded and reserves both domestic and foreign increased dramatically. Also, predictably, as prices rose, we used less, and by the fall of 1981, both the U.S. and the world had a surplus producing capacity of both oil and gas relative to the market.

"Now, what has happened since 1981? First, the world price of crude oil has fallen from $38.00 per barrel to about $26.00 per barrel. Prices for the expensive deep gas have fallen from the $8.00-$9.00 range per MCF to $2.50-$2.75 range per MCF. Also, the gas transmission companies have reduced the volumes they take to levels significantly lower than they were in 1981. The domestic drilling rig count has declined from 4,600+ in the fall of 1981 to 2,100+ last week, and has dropped about 100 rigs per week for the last 7 weeks. (Coincidentally, this rapid drop started right after the Treasury Department's new tax proposal was unveiled.) Today, we have an industry that is in disarray. Large segments of it, particularly the oil services part which expanded too rapidly, and many independents are already in bankruptcy or near to it. Some sizeable banks which lend to the industry have already failed and many more are in deep trouble. This brings me to the point of this statement.

"What does the Treasury propose for an industry already flat on its back? It proposes to 'reform and simplify' our taxes again and in so doing, to repeal among other things: (1) its ability to charge off intangible drilling costs on all wells, even those which are dry and incapable of producing, (2) the percentage method of calculating depletion, and (3) all investment tax credits. The Congress in its wisdom created these charges against income many years ago realizing that the search for oil and gas is a very high risk business. Historically for our company, more than 60 percent of all wells we drill are dry.

"How will this affect our company? Over the next 5 years we will pay $116,348,000 more dollars in Federal income tax which is an increase of 69.85 percent over what we would pay under the current tax law. This reduction in cash flow will severely restrict our exploration efforts in the future years and this effect will be mirrored by the industry as a whole, majors and independent producers alike.

"What will happen to the domestic oil and gas industry? The independent producer, who has been responsible for discovering approximately 80 percent of the new domestic reserves of oil and gas will virtually disappear in 5 to 10 years. Major oil companies and large independents who receive no funds from individual investors will continue to explore but will increasingly turn to foreign areas which are more profitable. A large part of the oil service industry will disappear as there will no longer be much domestic need for these services. Hundreds of thousands of jobs will be lost (over 90,000 in Oklahoma) as well as the taxes therefrom. The Treasury will collect more tax from the oil industry for a couple of years and then this tax base will rapidly begin to disappear. As a consequence, this country will become more dependent on foreign oil and whatever that portends in terms of national security, balance of payments, etc. In my view, the Treasury proposals that apply to the oil industry, if enacted in their present form would constitute a national tragedy."

If you have any questions regarding the above statement, don't hesitate to contact me.

Sincerely,

Sam Noble

SN:ple

Senator NICKLES. Mr. Noble, thank you very much for your comments.

Mr. Potts.

STATEMENT OF RAY POTTS, PRESIDENT, PSEC, INC., OKLAHOMA CITY, OK

Mr. POTTS. Senator Nickles, and members of the Senate Energy and Natural Resources Committee, my name is Ray Potts, and I am the immediate past president of the Oklahoma Independent Petroleum Association. I have been involved in the oil and gas business for some 26 years.

I currently own my own company. We employ about 25 people. During this period of time of my involvement in the business, I have probably been associated with the causing or participating in the drilling of probably 500 wells.

In the limited time available to me today I would like to address two specific areas of the Treasury proposed flat tax rule changes wherein I believe that the Treasury people have made serious erroneous assumptions.

The first one, taxpayers in the oil and gas industry receive favored treatment through percentage depletion and expensing of intangible drilling cost.

I would like to read from the Treasury's own language, and I quote:

"The expensing of IDC's provides a tax benefit for capital investing in the oil and gas industry. Because investment in oil and gas is tax favored," and I underline tax favored, "capital is diverted from other more productive economic activity."

The Treasury people are great for saying that they want everybody to play on a level field. Having been to Washington two or three times, I have heard this statement made several times. "We want to get everybody treated exactly the same. We want to play on a level field."

I submit, sir, that is like everybody in the world being born with exactly the same IQ.

I also submit there is no such thing as a level playing field. Each business venture has a different risk factor.

Let me give two examples. One venture would be a shopping center and another would be a wildcat well. An investment of capital into a shopping center is not likely to lose the entire investment, while the odds are 9 to 1 that the capital put into a wildcat well will be lost.

Because of the high risk factors associated with the oil and gas industry, Congress, when it passed the initial revenue statutes dealing with IDC's, recognized the inherent risk of the oil industry that was needed to attract the necessary capital to do the drilling that we have to do.

And likewise, percentage depletion was passed in order to attract capital into a venture such as oil and gas that has a definite determinable life. Over 90 different minerals and depletable products receive some type of statutory treatment.

The reason, I think, is quite simple. An example would be if I own a farm and I fertilize and rotate crops, I can make that farm produce forever. But yet if I find an oil pool, there is nothing I can do to extend the life of that.

Congress in its wisdom saw that it was necessary to consider these risk factors and the depletable nature of the oil and gas investments.

And that is why I submit, sir, that we are not favorably treated and that we do not play on equal ground, a level playing field.

The second serious erroneous assumption I feel the Treasury people make is that the independents do not make a significant contribution toward meeting the country's energy needs.

Historically, independents account for 90 percent of all wildcat drilling in the domestic 48 States, and 85 percent of all drilling. Independents find more than 80 percent of significant new reserves, new discoveries, and account for 56 percent of the new reserves found.

It would probably be higher than that, really, because independents frequently sell out to majors. That is why they do not retain those reserve figures.

I would also like to point out during the last 10 years in the lower 48 States crude oil production has dropped from 9 million barrels a day to 7 million barrels. This loss of 2 million barrels of production per day occurred primarily through the major oil companies' production and not through the independents.

As a matter of fact, the independents' share of production actually increased in 1980 from about 2½ million barrels a day to around 3 million barrels a day.

I would like to point out that the Nation can ill afford to lose 15,000 independent producers. They are an essential part of a stable domestic energy scene. Independents are a little bit like grains of sand. Each one of us are insignificant, but when put together, the grains of sand form beautiful beaches.

That is the same way with independents. We are like farmers. This country's food, as one of the gentlemen pointed out this morning, is grown by the small farmer, not the large farming tracts.

That is the same way it is with the oil business. This country depends on the independents, not the major oil companies.

Sir, I would urge that this committee study very carefully the effects of the Treasury Department's proposed flat tax on the domestic oil and gas industry. At a time when we are trying to adjust to falling oil prices, also falling gas prices, shut-in gas wells and a decreasing source of capital, the enactment of the Treasury's proposal would be of devastating effect for the independent producers of this Nation.

Thank you, sir.

[The prepared statement of Mr. Potts follows:]

Senator Nickles and Members of the Senate Energy and Natural Resources Committee:

I am a geologist and an independent oil and gas producer and have been active in searching for oil and gas for 26 years. Currently, I am President of a small company that I have built which employs 25 people. During this period of activity, I have probably been associated in one form or another in over 300 prospects which have resulted in the drilling of at least 500 wells.

In the limited time available to me today I would like to address two specific areas of the Treasury proposed flat tax rule changes wherein I believe the Treasury people have made serious erroneous assumptions:

First: That taxpayers in the oil and gas industry receive favored treatment through percentage depletion and expensing of intangible drilling cost.

(Quote from Tresury's own printing.)

The Treasury people are great for saying they want everybody to be playing on the same level playing field. I submit that there's no such thing as a level playing field - each business venture has different risk factors. Let's take two examples: One venture is a shopping center and another is a wildcat well. An investment of capital into a shopping center is not likely to result in the loss of the entire investment while the odds are 9 : 1 that capital put in the wildcat well will be lost. Because of the high risk factor associated with the oil and gas industry, Congress when it passed the initial revenue statutes dealing with IDCs recognized the inherent risk needed to attract capital.

Likewise percentage depletion was passed in order to attract capital into a venture such as oil and gas that has a definite determinable life. Over 90 different minerals and depletable products receive some type of statutory depletion.

I submit that when the risk factors associated with drilling and the depletable nature of oil and gas investments are considered, the oil and gas industry does not receive favored tax treatment.

The second serious erroneous assumption I feel the Treasury people make is that the independents do not make a significant contribution towards meeting the country's energy needs.

Historically, independents account for 90% of all wildcat drilling and 85% of all domestic drilling. Independents find more than 80% of significant new discoveries which account for 56% of new reserves found. Between 1973 and 1982, independents reinvested 108% of their generated revenue into new drilling.

During the last ten years Lower 48 crude oil production has dropped from 9 to 7 MMBPD. This loss of 2 MMBPD production occurred in the major oil companies' production, not the independents'. The independents' share of production actually increased in 1980 from about 2.5 MMBPD to 3 MMBPD.

This nation can ill afford to lose any of the 15,000 independent producers. They are an essential part of a stable domestic energy scene. Independents are like grains of sand on the beach - each grain by itself is insignificant, but when grouped together these grains of sand form beautiful beaches.

I urge this Committee to study very carefully the effects of the Treasury department's proposed flat tax on the domestic oil and gas industry. At a time when we are trying to adjust to falling oil prices, shut-in gas wells and a decreasing source of capital the enactment of the Treasury proposal would be devastating to the independent producer.

Ray H. Petts
Suite 200, 100 Park Ave Bldg

Senator NICKLES. I thank you very much, Mr. Potts.

How many independent producers do we have in the State of Oklahoma?

Mr. POTTS. Well, we have probably in the neighborhood of some 7,000 total businesses associated with it. There are 1,500 members paying dues, dues-paying members of the Oklahoma Independent Petroleum Association.

Senator NICKLES. Mr. Noble, you mentioned that there are what, 2,100 active rigs——

Mr. NOBLE. Correct.

Senator NICKLES [continuing]. Right now in the country, as compared to 4,500 2 years ago?

Mr. NOBLE. That is right.

Senator NICKLES. Your company is active in the drilling business. Are most of your rigs active or do you have a bunch idle?

Mr. NOBLE. No, sir; we are running right now, we are a little—well, about 51 percent, I think, last week. That is better than the industry.

Senator NICKLES. So, you have about half of your rigs running, but in most of the industry the figure is more like 40 percent or less?

Mr. NOBLE. If you were a land driller, and even in our case, it would be far less, because our water operations—well, over a third of our rigs, are water rigs, and those are about 90 percent utilized now.

So, our land rigs are probably in the 30-percent utilization.

Senator NICKLES. So, the biggest decline has been in the 48 States, not the offshore?

Mr. NOBLE. Yes, sir.

Senator NICKLES; Mr. Potts, you were talking about the value of the independent structure. Some people might argue, and I haven't heard it, nor did we hear it from the majors, but some will say, "Majors do not have percentage depletion, only independents do. Why should independents have percentage depletion?"

How would you answer that kind of question?

Mr. POTTS. Well, two or three different ways, sir.

First of all, I think the majors do have a certain category of percentage depletion.

The second reason, I think the most important reason for the independents, has been mentioned several times here today. We invest 108 percent of our cash-flow each year, and percentage depletion is an important source of attracting capital to drill the wells that we have to drill.

Also, the percentage depletion is extremely important, and this is the point I think is frequently lost sight of. If I have a producing well, you hear nonoil people say, "Why should you get tax benefit on the income from that well?" For example, if I earn $100 from a well, I only pay taxes on $85.

That is my source to drill the wildcats that the majority of them are going to be dry, and only wildcats are where you find a new pool.

So, it is important that I get percentage depletion, not only on my development production, my wildcat wells, but it is a seed.

It is a little bit like we send seed to an underdeveloped country to grow crops for that nation to eat out of. To do away with my percentage depletion would be like taking that seed in these undeveloped nations and cooking it and eating it, rather than cultivating it to grow more crops.

So, that is the devastating effect of percentage depletion, as far as removal of it.

Senator NICKLES. Either one of you can answer this question. Mr. Noble, you kind of touched on it. You said the industry is already pretty much on its back. Certainly it is on its back if it only has 2,100 rigs compared to 4,500.

Both of you have been in the drilling industry and the oil business in Oklahoma for some time. If these proposals did go through, we will have a lot of producers that will go out of business. We have also seen several banks go upside down in the State of Oklahoma.

You mentioned, Mr. Potts, 1,500 dues-paying members and maybe 7,000 oil businesses in the State of Oklahoma.

If these provisions went into effect, what percentage of those producers and oil-related businesses do you think would go out of business?

Either one of you.

Mr. NOBLE. I think they would all go out of business over a 10-year period, because who is going to keep risking their money with no incentive?

You know, there are better games. People that are smart enough to make money in the oil business probably are smart enough to make money in something else, the stock market, or what have you.

If they take out all of our incentives that we have, then people are just going to quit. That is what I believe as an individual, and I suspect there is a whole lot more.

Senator NICKLES. So Noble Drilling has been in business——

Mr. NOBLE. Sixty-plus years, since 1921.

Senator NICKLES. 1921. It might fold the tent and look for—

Mr. NOBLE. I think you are going to see that in the oil service industry a lot. You cannot afford to stay.

Senator NICKLES. Mr. Potts?

Mr. POTTS. I would guess 50 percent right away, and after hearing Mr. Noble's comment, I agree that over a period of time that would happen.

I think it is important to point out that those of us who are established in the business will survive somehow, but the important point is that there will not be newcomers, new people, new industries coming in to drill additional wells.

I would like to point out that during the heyday, when we drilled the largest number of wells that were ever drilled in the history of this country, starting late 1979 through 1982 or 1983, that the number of wells drilled per operator was about five and a half wells, but there was suddenly a great increase in the number of operators that came into the business with the attractive price, the incentives that were offered during this period of time.

So, it was the number of increased new operators that made it possible to drill additional wells that turned around the declining production in this country.

So, not only are we worried about just status quo of keeping those in existence, but it does not allow any opportunity whatsoever to attract new investors, new people who are not established to make it in the oil business. They just cannot do it.

Senator **Nickles**. How do you answer somebody who might take the Treasury argument and say, "Well, now, we will take away these incentives and yet, granted, we will admit that the number of wells will decline and a lot of businesses will go out of business but eventually our dependence on OPEC and the shortage of oil, since we are producing a lot less, will drive the price up, and so sometime out in the future prices will increase, and then there will be another healthy domestic oil and gas industry"?

Mr. **Potts**. I will take a quick shot at that first, because I just thought of a comment that a Treasury official said recently when we were in Washington, D.C. He said something to the effect that, "We really don't care about the independents, except in about 1992 it will be a good time to come back in."

I do not think, sir, that we can tread water that long and we will be able to stay in the status quo that we can survive this period of time.

Mr. Hambrick this morning, of Kerr-McGee, was pointing out in response to a question you asked about amortizing the expense of IDC, instead of expensing them, amortizing them over a 3-year period, the problem that all of us would face, it is true that on paper and over a period of time, whatever increment you use, we would be back to the same position, except we can't survive that long.

We cannot do without that source of income during that transition period. We would not be able to survive, and that is the problem with the Treasury's position. They say you would be exactly in the same position you would be once you reach that point, wherever it is down the line, that your financial situation would be identical. We can't get from here to there. The patient won't live.

Mr. **Noble**. Senator, we almost died, the whole industry. That is what I was trying to point out, from the fifties to the seventies.

Just take geologists. The University of Oklahoma, when I went to school down there, they probably graduated 50, 60 or 70 geologists a year. It got down to where they were graduating two or three a year. And this is true of the University of Texas. There wasn't any market for them.

There wasn't any market for petroleum engineers, and when we got into this boom in 1978, that was one of the worst times in my life, because we had no trained people.

OK. We went from bust to boom and we trained all these people and now we are going the other way. It is like Ray said, I don't think we can survive another 15 years like that, or however long it took.

Senator **Nickles**. Gentlemen——

Mr. **Potts**. Can I just say one more thing?

Senator **Nickles**. Sure.

Mr. **Potts**. The point that is frequently lost, I think as a geologist I have learned to appreciate the element of time.

Once you dismantle an industry, you cannot turn it around overnight. You cannot make up that loss of time.

I use as an example like a young married couple that is going to have a baby. They would like to have that baby soon, but there is nothing they can do to hurry up that 9 months' period, no matter what it is.

That is the same way. Once you dismantle a domestic industry, it goes out of business, and you don't have the trained geologists, and you don't have any trained drillers. You don't have the technicians that you need, and then once you do start gearing up, from the time the prospectors can see by the geologists telling us to drill to oil production is 3 to 5 years.

We can ill afford to depend on an unstable foreign source during this period of quiescence and while we are trying to revamp. So, we cannot lose the momentum that we have now, which is what the Treasury's officials would do.

Senator **Nickles**. I appreciate your comments, and than you very much.

On our next and final panel, we have John Braden, who is a partner with Arthur Young & Co. from Tulsa, Huston Huffman, senior vice president of First National Bank, Oklahoma City; Jack Riley, a CPA from Ardmore; and Mark Stansberry, senior vice president of the First National Bank in Elk City.

Mr. Braden.

STATEMENT OF JOHN R. BRADEN, PARTNER, ARTHUR YOUNG & CO., TULSA, OK

Mr. **Braden**. Good morning, Mr. Chairman.

My name is John Braden. I am a tax partner with Arthur Young & Co. in the Tulsa office.

As a tax practitioner, I would like to echo the comments of others here today that the Treasury Department's tax reform proposals which repeal the current deductibility of intangible drilling cost and the allowance for percentage depletion would have a significant negative impact on exploration and development activity in the oil and gas industry.

Although the reduction in marginal tax rates to some degree offsets the repeal of these traditional tax incentives over the productive life of any individual property, the requirement to capitalize intangible drilling costs by itself appears to reduce the producer's available cash flow by approximately 30 percent under most typical fact patterns.

Drilling activities obviously have to be financed from some source and lost cash flow from operations must be replaced either from additional outside investment or from bank borrowings.

These proposals, combined with the reduction of marginal tax rates, substantially reduce the attractiveness of oil and gas activities to outside investors who provide critical capital to the industry.

The availability of tax incentives would no longer alleviate the substantial risk of exploration, and the after-tax rate of return on alternative investments, such as bonds, Certificates of Deposit, and high-yielding stocks, would be significantly improved over that that is available under the current law.

Thus, most investors would likely, at least in the short term, reduce their aggregate oil and gas investments by an even greater amount than the mere reduction in cash flow from operations.

The combination of these two factors and the spectrum of uncertainty they create can only serve to decrease financial institutions' willingness to take the petroleum risk.

The impact of these factors on drilling activity and the oil and gas industry as a whole would, in my opinion, be significant and unavoidable.

The Treasury proposal to reform and simplify the tax system appears to a large degree to be based upon the perception that the public believes the tax system to be unfair and that the system serves to distort the overall allocation of resources in the economy.

The proposal is similarly based upon the perception that in the absence of tax incentives the marketplace will adjust through the principle of supply and demand to achieve the maximum utilization of our natural resources.

These perceptions obviously have academic merit; however, their accuracy in real life is subject to great question.

Proposals such as this which entail a fundamental shift in the tax system away from mechanisms for achieving public policy goals to a system which merely serves to finance the operation of Government should be undertaken only after careful review and analysis of their overall national impact.

And at least publicly, however, there is almost a complete absence in the Treasury's proposal of detailed consideration of the economic dislocation that will inevitably result throughout all sectors of our industry.

This is particularly true with respect to the impact on domestic drilling activity and production and reserve of natural gas.

Sound public policy would seem to require careful and open deliberation as to whether the perceived results on these proposals will in fact be achieved or whether the cure is worse than the disease.

As an observer of the economy, I think it is highly doubtful that supply and demand factors can adjust in any meaningful way in response to changes in Federal taxation.

For example, in the State of Oklahoma, it is my estimate that nearly 70 percent of total exploration expenditures during 1983 were attributable to drilling for natural gas.

As you and other members of this committee are well aware, the natural gas industry, as a result of regulation of producer prices, the regulation of the transportation and distribution system and prior contractual arrangements is characterized by a high degree of inflexibility in responding to changing market conditions.

This structure will, of course, change over time; however, any change will, without question, be very slow and very painful.

In addition, crude oil prices, set by a foreign cartel in an international marketplace which is not significantly affected by either domestic supplies or by domestic demand, cannot be expected to respond merely as a result of changes in U.S. Governmental tax laws relative to oil and gas taxation.

There is little indication that these realities of the oil and gas business today have been given consideration in the Treasury's analysis of the impact of their proposals on the industry, the economy and the country.

Tax provisions which provide incentives and recognize the unique risk of oil and gas investments have existed since the inception of the income tax. Taxpayers understand and expect this treatment.

Despite its flaws, I think our current tax system appears to be essentially rational in the way it deals with the complexity of business transactions in our society today. Whatever economic distortions that result from the various incentive provisions are at least known and observable. We have accommodated to the system.

The consequences of change, both intentional and unintentional, however, are unknown and they are essentially unanalyzed.

The taxation of oil and gas investments, along with taxation in general, has been the subject of major annual revisions for the last 10 years. Continual significant changes, more than the nature of the changes themselves, have been the major contributor to the perception of complexity, unfairness and lack of efficiency of the Federal income tax.

Taxpayers, tax professionals and the Department of Treasury and the Internal Revenue Service are required to devote incredible resources simply to absorbing such items as changes to the way depreciation is computed, to implementing the recordkeeping requirements or implementing new taxes, such as the windfall profit tax.

In my opinion, we would ultimately be far better served by a stable tax system which would permit long-range business decisions than by a sweeping reform that would change the entire playing field. By its very nature, such a fundamental reform would preclude stability for the foreseeable future, due to the inevitable changes that would be necessary to correct for unintended or unpopular consequences.

The current deductibility of intangible drilling costs and an incentive allowance for depletion have survived in the overall scheme of Federal taxation for nearly 70 years.

These provisions have survived changing economic conditions and changes in the makeup of Congress because in the final analysis they have been considered to make good sense and generate overall economic benefits that far exceed any perceived direct revenue loss.

Thank you very much.

[The prepared statement of Mr. Braden follows:]

Statement of John R. Braden
Before the United States Senate Committee
On Energy and Natural Resources
Oklahoma City, Oklahoma
February 15, 1985

Good morning, Mr. Chairman and thank you very much for the opportunity to appear here today on these important matters. My name is John Braden. I am a partner in Arthur Young & Company located in the Tulsa office although I am appearing here today to express my own opinions and not those of the firm.

As a tax practitioner, I would like to echo the comments of others here today that the Treasury Department's tax reform proposals which repeal the current deductibility of intangible drilling cost and the allowance for percentage depletion would have a significant negative impact on exploration and development activity in the oil and gas industry. Although the reduction in marginal tax rates to some degree offsets the repeal of these traditional tax incentives over the productive life of any individual property, the requirement to capitalize intangible drilling costs by itself appears to reduce the producer's available cash flow by approximately 30% under typical fact patterns. Drilling activities obviously have to be financed from some source and lost cash flow from operations must be replaced either from additional outside investment or bank borrowings. Repealing the deductibility of intangibles and the allowance for percentage depletion combined with reduction in marginal tax rates substantially reduces the attractiveness of oil and gas activities to outside investors who provide critical capital to the industry. The availability of tax incentives would no longer alleviate the substantial risk of exploration and the after-tax rate of return on alternative investments such as bonds, certificates of deposit and high yielding stocks would be significantly improved over that available under the current law. These investors would likely, at least in the short-term, reduce their aggregate oil and gas investments by an even greater amount than the mere reduction in cash flow from operations. The combination of these two factors and the spectrum of uncertainty they create can only serve to decrease financial institutions willingness to lend. The impact of all these factors on drilling activity and the oil and gas industry as a whole would in my opinion be significant and unavoidable.

The Treasury Proposal to reform and simplify the tax system appears to a large degree to be based upon the perception that the public believes the tax system to be unfair and that the system serves to distort the overall allocation of resources in the economy. The proposal is similarly based upon the perception that in the absence of tax incentives the market place will adjust through the principles of supply and demand to achieve the maximum utilization of our natural resources. These perceptions if true obviously would have academic merit, however, their accuracy in real life is subject to great question. Proposals such as this which entail a fundamental shift in the tax system away from a mechanism for achieving public policy goals to a system which merely serves to finance the operation of government should be undertaken only after careful analysis and review of their overall national impact. At least publicly, however, there is almost a complete absence of detailed consideration of the economic dislocation that will inevitably result. This is especially true with respect to the impact on domestic drilling activity, and production and reserves of oil and gas. Sound public policy would seem to require careful and open deliberation as to whether the perceived results on these proposals will in fact be achieved or whether the cure is worse than the disease.

As an observer of the economy, I feel it is highly doubtful that supply and demand factors can adjust in any meaningful way in response to changes in federal taxation. For example, in the state of Oklahoma, it is my estimate that nearly 70% of total exploration expenditures during 1983 were attributable to drilling for natural gas. As this committee is well aware, the natural gas industry as a result of regulation of producer prices, the transportation and distribution system and contractual arrangements is characterized by a high degree of inflexibility in responding to changing market conditions. The structure of the market place will of course change over time, however, any change will without question be very slow and extremely painful. In addition, crude oil prices, set by a foreign monopoly in an international market place which is not significantly effected by either domestic supplies or domestic demand can also not be expected to respond merely as a result of changes in U.S. governmental tax policy, relative to oil and gas tax incentives.

There is little indication that these realities of the oil and gas business today have been given consideration in the Treasury's analysis of the impact of their proposals on the industry, the economy and the country.

Tax provisions which provide incentives and recognize the unique risk of oil and gas investments have existed since the inception of the income tax. Taxpayer's understand and expect this treatment. Repealing these provisions, without question, changes the economics of a drilling venture and investor psychology. The reduction in marginal tax rates promised in the proposed reforms will not be sufficient to offset the real negative impact of the loss of current deductibility of intangibles and depletion in the minds of investors. Despite its flaws, our current system appears to me to be essentially rational. Whatever economic distortions that result from the various incentive provisions are at least known and observable. We have accommodated to the system. The consequences of change, both intentional and unintentional, however, are unknown and essentially unanalyzed.

The taxation of oil and gas investments, along with taxation in general, has been the subject of major annual revisions for the last 10 years. Continual significant changes, more than the nature of the changes themselves, have been the major contributor to the complexity, apparent unfairness and lack of efficiency of the federal income tax. Taxpayers, tax professionals and the Department of Treasury must devote incredible resources simply in absorbing such items as, the changes to depreciation provisions, to the new recordkeeping requirements or to implementing the new windfall profit tax. Regulations on the changes to the percentage depletion provisions made in 1975 have never been finalized.

In my opinion, we would all be far better served by a stable tax system that would permit long-range business decisions than by a sweeping reform which would change the entire "playing field." By its very nature such a fundamental reform would preclude stability for the foreseeable future due to the inevitable changes that would be necessary to correct for unintended or unpopular consequences.

Price instability, excess foreign production, investor uncertainty and the unwillingness of lenders to take new petroleum risks have combined to create a deep and continuing recession in all sectors of the oil and gas industry. This recession puts great financial pressure on many producers who may not have resources to deal with additional negative factors. The current deductibility of intangible drilling costs and an incentive allowance for depletion have existed in various forms for over 70 years. These provisions have survived in the overall scheme of federal taxation through changing economic conditions and changes in the make-up of Congress because in the final analysis they have been considered to make good sense and generate overall economic benefits far exceeding any perceived direct revenue loss.

Senator **Nickles**. Thank you very much, Mr. Braden. We appreciate your comments.

Mr. Riley.

STATEMENT OF JACK B. RILEY, CERTIFIED PUBLIC ACCOUNTANT, ARDMORE, OK

Mr. **Riley**. Good afternoon, Mr. Chairman. I certainly appreciate being here.

I am Jack Riley. I am a certified public accountant from Ardmore, OK.

You know, just earlier Mr. Ray Potts gave a good description of the independent producers of this State and of this country. But another important characteristic of this group of producers is that they are primarily closely held corporations, family partnerships or proprietorships.

And, Senator, these groups will not get the advantage of the proposed deduction for one-half of the dividends paid. This dividend deduction would not provide any new jobs. It would not provide any additional funds for drilling. It would not be of benefit to any of the independent producers of this country.

The Internal Revenue Code has always distinguished between closely held corporations and publicly held corporations, and I think that it would not provide that kind of a deduction for these closely held corporations.

Instead of taking the usual Government approach to drafting new legislation, let us consider a joint venture of Government and industry to draft new tax legislation, one that provides the necessary incentives for investment, promoting exploration in productive fields, and encouraging continued production from existing wells.

Surely it is preferable to cooperate on acceptable proposals then to have to defend unacceptable considerations or rewrite regulations that cannot be defended. The most recent case is the travelog documentation regulations, which gave such widespread taxpayer disconsent, that there was some significant modification.

I think the taxpayers of this country, Senator, feel like we are simply the responders to Government, instead of those who should contribute to its formation.

If we actually have to capitalize intangible development costs, let us consider an investment tax credit of perhaps 20 percent, and a shorter amortization period for those costs that go into riskier and more expensive exploratory wells.

All costs necessary for exploration should be included, especially those geological/geophysical expenses that now have to be capitalized as lease-hole costs and are subject only to cost depletion.

Cost of drilling a developmental well might receive a 10 percent investment tax credit and be amortized over a longer period of time, perhaps 5 years.

Costs of drilling a dry hole should be expensed as they are occurred in order to recognize the loss of capital and the lack of market value of the end product.

Furthermore, percentage depletion should be retained for existing and future wells that produce less than 10 barrels per day in order to encourage continued production from these otherwise marginally productive wells.

Because statutory depletion is supposed to be a deduction to offset the utilization of a wasting asset, it seems logical to allow depletion on these commercially marginal wells in order to offset their continually declining value.

Once agreement on tax reform legislation has been reached by all parties, let us consider a 5-year moratorium on tax legislation. This will give producers and investors a sense of stability and security, and would allow them to make decisions, knowing that future revenue streams would be subject to consistent tax rates and regulations.

If it is given that the tax policy of this country is to direct the economic development by encouraging investment in certain industries, who is to decide which industries are favorably treated and which are not?

Who will respond to the fears of hundreds of thousands of displaced workers, and who will answer to the questions of national security concerns for the rest of this decade?

It would seem logical to use tax policy to make existing industries more attractive for investors, encourage efficient economies and expand production, resulting in the growth of the employment base, increase in tax collections, decrease of trade deficits, and enhancement of Federal national security.

Finally, Senator, we need to recognize that people find energy and make petroleum. It takes individuals with the intelligence and capability to take the flecks of oil from this rock and create the crude that is then refined. It is not done by tax policy, officebound bureaucrats or big-room computers.

In order to encourage experienced professionals to stay and gifted students to choose the related energy professions, the chances for success must be obvious and must be consistently obvious.

If we do not replace the older geologists and engineers with capable graduates, all of the tax programs will be of very little consequence. There will be continually decreasing reserves which will annually be supplemented at a declining rate.

The domestic energy industry has provided this country with a reliable energy source for almost 80 years.

Tax reform should continue its success, not begin its termination.

Thank you, Senator.

[The prepared statement of Mr. Riley follows:]

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Memorandum for Hearing regarding the potential effects of the energy provisions of the Treasury Tax Simplification Proposals
February 15, 1985
Submitted by: Jack B. Riley
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It appears the administration is trying to do everything it can to widen the gap of misunderstanding between those who govern and those who are governed. While the bureaucrats talk of operating in an "International Free Market Economy," with all goods and services being purchased at the lowest price, the industry experts face the reality of extensive unemployment, widespread industry recession and the ultimate doomsday prospect of threatened national security. So, who is right? Will the national economy be sacrificed for the goal of worldwide free trade? This devastating effect may seem to be blown out of proportion in relation to the two proposals - elimination of the statutory depletion allowance and required capitalization of intangible drilling costs and dry hole costs. However, the projected loss of more than 600,000 jobs nationwide, and the estimated decrease in domestic production by more than 45,000,000 barrels of oil annually could easily lead to this conclusion.

Sometimes it appears as if our tax policy is aimed at "The Average Taxpayer" and our economic goals are aimed at the "Average Investor." These two mythical characters have done more to alter national policy than elected representatives. How can there be such a person as the average taxpayer? If there is anything average about taxpayers, it is that they cannot read the tax code proposed changes in the tax code to satisfy the polled demands of this group. The major problem separating us is a matter of communication. It is not possible to communicate 30 years of tax codification and regulation, as well as the underlying legislative motivation, in a form all taxpayers could digest and understand. Yet without this background the average taxpayer will always respond with suspicion to questions about his relative tax position, and will always be resentful of others with perceived lower tax costs.

Perhaps an appropriate question here is - "Is the current tax code working?" In one sense the answer would be "Yes"; our productivity growth in the last year has been near a record pace with surprising gains in the gross national product . Yet conversely, there is widespread confusion and distrust about the taxing process among those who are the very benefactors of it. For the average taxpayer, of whom there are now record numbers, believes that they are unjustly taxed because someone may have made more money but paid less tax, by using "TAX SHELTERS". Too few average taxpayers realize that their very jobs may be the result of utilization of a tax shelter. Offices, apartments and other buildings are built for the benefit of the deductible depreciation, or are financed with funds from retirement accounts; equipment, purchased to make employees more productive, benefits the buyer with investment tax credits and depreciation. Workers in the construction and manufacturing value their jobs, but do not realize the direct relationship between their employment and the investment incentive created by the tax shelter effect. The economy operates with these tax policy incentives and their removal will ultimately have an adverse effect. We are all in this together; investors, carpenters, engineers, welders, and other laborers all benefit from this macroeconomic perspective of the tax code and its stimulative effects. Any tax reform must continue to recognize the combined role of capital, energy and tax policy in the economic process.

It is important here to identify what group is really affected by the proposed legislation - it is not the major oil companies like Mobil, Exxon and others, who in recent years have used their surplus funds to diversify into other industries or to acquire proven reserves; rather it is the independent energy producer who is the direct target of these considerations. As a group the independent producers are the most likely to take the risk of exploration, they have drilled 90% of all wildcat wells, perform 85% of all domestic drilling and have accounted for more than 56% of all new reserves. Because historically, only about one-third of all drilling funds are from outside investors, and because independents are not able to drill exploratory wells with borrowed money, 108% of gross production revenues were reinvested in the ten years ended in 1983 by independents.

Another important distinction between independents and the majors is that independents are primarily closely held corporations, family partnerships or sole proprietorships. Thus they will derive absolutely no benefit from the proposed deduction for one-half of the corporate dividends paid to stockholders. The Internal Revenue Code always distinguishes between closely held corporations and publicly held corporations; it's very doubtful that closely held corporations will be allowed to take advantage of the dividend paid deduction. This deduction would have no value to independents anyway - it does not replace diminishing reserves, add production for future years, or even create new jobs. All it does is to help offset the double taxation effect for publicly held corporate dividends, and thereby encourage our "Average Investor" to invest in equity securities, and thus further eliminate the incentive for the outside investors.

Now how does all this relate to the immediate problem of the the oil industry and the administration proposals? If the tax shelter incentives of statutory depletion and write-off of intangible drilling are removed, over 600,000 of the average taxpayers will be unemployed. So let's not devastate an industry and create unemployment to solve a problem that may really be a matter of communication and perception. Instead let's form a new joint-venture of government and industry to to draft new tax legislation that provides the necessary incentives for investment, promote exploration of new productive fields, and encourage continued production from existing wells, and yet can hopefully be judged to be fair and equitable. We should all recognize that an income producing asset, the Internal Revenue Code is obsolete and needs to be replaced. But instead of taking the typical approach, why not combine experts from the industry being affected to aid in drafting legislation that can be acceptable to both parties? Surely it is preferable to cooperate on acceptable proposals than to have to defend unacceptable considerations, or rewrite regulations that cannot be defended. The case of the travel log documentation regulations being the most recent example of widespread taxpayer discontent, expressed so adamantly that the significant modification resulted.

The rate of drilling exploratory and development wells decreased 36% in 1983, current proposals would only hasten the decline. If the administration is really serious about encouraging exploration, consider an investment tax credit of 20% for capitalized I.D.C. and a shorter amortization period for costs of drilling the riskier and more expensive exploratory well. All costs necessary for exploration should be included, especially those geological and geophysical expenses that now have to be capitalized as leasehold costs subject to cost depletion. Cost of drilling a developmental well, might receive a 10% investment tax credit and be amortized over a longer period, perhaps five years. Cost of drilling dry hole wells should be expensed as incurred, in recognition of the loss of capital and the lack of substantial market value.

Percentage depletion should be retained for existing and future wells that produce less than 10 barrels per day, (stripper wells by D. O. E. definition) to encourage continued production from these otherwise marginal wells. If the statutory depletion were to be removed, many of these wells would no longer be commercially profitable to operate and they would be plugged, eliminating a large supply of our national production. ~~It has been estimated that more than [illegible] barrels of our annual production comes from stripper wells~~. Because statutory depletion is supposed to be a deduction to offset the utilization of a wasting asset, it seems logical to allow depletion on these commercially marginal wells to offset their continually declining value. When you consider the theory of a "wasting asset", you recognize the difference between an investment in energy production and building construction; the building will always be there and have a value, but as reserves are produced the well's value decreases and future removal costs per unit of production increase. Cost depletion is of no benefit to these older wells, because their costs have been recovered in prior years. In those few cases where cost depletion might apply, the calculation is very complex and will only add to the inefficiency of administering these properties.

Once agreement has been reached by all parties, a five year moratorium of tax legislation should be provided. This would give producers and investors a sense of tax security, and allow them to make decisions knowing that future revenue would be subject to consistent tax rates and regulations.

If it is given that the tax policy of this country is to direct economic development by encouraging investment in certain industries, who is to decide which industries are in a favorable trend and which are not? Who will respond to the fears of hundreds of thousands of displaced workers, and who is to answer for the national security concerns of the next decade? It would seem logical to use tax policy to make existing industries more attractive for investors, encourage efficient economies and expand production, resulting in the growth of the employment base, increase in tax collections, decrease of trade deficits, and enhancement of national security, rather the increasing unemployment and national debt. The domestic energy industry has provided this country with reliable energy for over 80 years; tax reform should continue its success, not begin its termination.

Finally, it has to be recognized that people find energy, not tax policy, office bound bureaucrats or big room computers. In order to encourage experienced professionals to stay, and gifted students to choose the related energy professions, the chances for success must be obvious. If we do not replace the older geologists and engineers with capable graduates, all of the tax programs will be of little consequence - there will be continually decreasing reserves that will annually be supplemented at a declining rate, until eventually lights will go off and cars will stay in garages.

Senator NICKLES. Thank you very much, Mr. Riley.

Mr. Stansberry.

STATEMENT OF MARK A. STANSBERRY, SENIOR VICE PRESIDENT, FIRST NATIONAL BANK, ELK CITY, OK

Mr. STANSBERRY. The Treasury Department's proposed energy tax plan would be detrimental to the energy industry and to the Nation as a whole. The plan, if implemented, could destroy our freedom and our security.

Both as a banker and as an oil and gas investor, I am disturbed that such a proposal is even being debated. There is no doubt in my mind that both the financial market and the energy industry will greatly suffer if the proposal is enacted.

The Treasury's energy tax idea alone has caused many oil and gas investors and companies to await a decision. The oil and gas independent, on the one hand, is highly concerned about the necessary funding.

On the other hand, the investor is hesitant about investing his money until Congress takes a stand. Therefore, our local economy and state economy come to a standstill.

The financial institutions and the energy industry are not the only ones to be affected if the intangible drilling costs and depletion allowance are repealed.

For example, John O'Hara, a retired western Oklahoma farmer, states that:

> If the oil and gas industry gets hurt that badly, they are not going to do any drilling, any exploring or any leasing. And if it was not for the oil and gas lease money, the farmers in this area would have in large numbers gone bankrupt.

Mike Jackson, a western Oklahoma businessman, states:

> From our standpoint, a great deal of our business is oil- and gas-related. If they curtail drilling any more, we are looking at the closing of a great percentage of our businesses in western Oklahoma.

Donald Royse, a western Oklahoma attorney and royalty owner, proclaims:

> We have to keep the oil and gas industry active. Anything that impedes drilling and expansion will slow down the whole economy.

In a conversation with Dr. J. Terry Johnson, the president of Oklahoma Christian College, we discussed the concern over the fact that higher education suffers when the economy suffers; that if the energy industry is burdened, then Oklahoma's higher education loses.

During the last oil and gas boom, Elk City, OK, enjoyed the increase in population and in the overall economy. Though Elk City and other western Oklahoma communities do not expect such boom times in the near future, we are hopeful that our economy will not have any more drastic downturns.

Enclosed in my report are figures and charts provided by Wayne Mackley, manager of the Elk City Chamber of Commerce, which displays a typical western Oklahoma town's economy over the past few years. The downturn in the annual sales tax receipts and city's active water meters at year end shows tremendous losses, which means more unemployment and a weakening in our local economies.

Financial institutions in western Oklahoma oppose the repeal of intangible drilling costs and depletion allowance. Phil Kliewer, president of the Cordell National Bank, Cordell, OK, comments:

> That the IDC and depletion allowance issue would be devastating not only to our direct energy relationships, but also to all the energy-related companies, such as service companies that are tied to the independents. They would be completely wiped out. We definitely would feel the repercussions through the domino effect.

Joe Williams, the President of the American Heritage Bank in El Reno, OK, explains:

> We definitely do not need to stop the oil and gas exploration at this critical time. Repeal of the IDC and depletion allowance would only encourage more foreign imports and, therefore, create drastic economic problems for our country. The energy market is being singled out and is already in deep trouble.

Most importantly, the oil and gas industry must not counter any more problems. As a study prepared by the College of Business Administration Department at Oklahoma State Univeristy, which is a part of this report, points out that:

With a pessimistic picture for energy prices, no significant growth can be expected in 1985 for rig activity or well completions.

Compounded with the fact that if the IDC and depletion allowance are repealed, then the American oil and gas industry falls.

Edward H. Leede of Leede Exploration, Midland, TX, explained to me that:

> We do not need anything else that makes it more difficult for us to help maintain our energy reserves in this country. There is no doubt that the worst thing would be the removal of the intangible drilling expense item and almost as bad is the depletion item which is important to independents who find so much of the new oil and gas. There would be a reduction in drilling at a time we don't need it.
>
> We do have an overdeliverability of gas right now, but before too long, though we don't know the time frame, there is going to be a turnaround and a situation again

> where we will have a shortage. The stronger the domestic industry is, the less we have to rely on uncertain imports. It is disastrous what it can do to the oil and gas business.

And only 2 days ago, Jaye F. Dyer, president and CEO of Dyco Petroleum Corp., Minneapolis, MN, makes the following observations for this report:

> Our primary area of interest and primary area of drilling activity is the Anadrako Basin in western Oklahoma and the Texas Panhandle. We are deeply concerned by the effect of the proposed Treasury's tax reform package will have on our business, specifically in the loss of the intangible drilling costs and the depletion allowance.
>
> Dyco Petroleum is a program company. We in 1980 commissioned an independent consultant in Washington, D.C., to do an analysis of our public drilling programs and their rates of return with full tax benefits and then without the intangible drilling costs and depletion allowance.
>
> What we found and what we learned, bottom line, was that the average internal rate of return for our programs from 1971 through 1977 was right around 21 percent. Then running those same programs through the model again without the depletion allowance, the internal rate of return for those programs on average fell to around twelve percent. Then without the intangible drilling costs, that rate of return falls to around ten percent.
>
> If you delete or take away the tax benefits derived from intangible drilling costs and the depletion allowance, the internal rate of return for those programs of ours falls to around four percent.
>
> So, with existing tax treatment, you have a very competitive investment which adds a lot of capital to the exploration industry. Without the benefit of the tax advantages, that source of capital will dry up because the investment can no longer be competitive.
>
> So, from our very narrow perspective to a more national perspective, it does not seem logical to us that in this day and age when energy security should be in the forefront of our minds, we are faced with a proposal which will only serve to drastically reduce domestic drilling activity, and in turn jeopardize any type of national security objectives we may have.
>
> The tax incentives are essential to capital formation in the oil and gas business and essential to the small independent producers like ourselves.

Included in my report are extracts from the Texas Railroad Commission's 1983 report telling a chilling story and factual one noting the fact that in Texas the gas reserves are 60 percent less than 15 years ago, an article entitled, "Nine Days on the Brink. '

It is written by James Nugent of the Texas Railroad Commission; and updated charts provided to me by W.J. (Bill) Murray, Jr., who formerly served on the Texas Railroad Commission and is now an energy consultant; and a copy of his speech delivered last summer in San Diego, CA, before the Interstate Compact Commission.

Also an article written by Mack Wallace a senior member of the Texas Railroad Commission; and other statements made by concerned bankers and citizens.

Thank you, sir.

[The prepared statement of Mr. Stansberry follows:]

TO: UNITED STATES SENATE COMMITTEE
ON ENERGY AND NATURAL RESOURCES

RE: REPORT ON THE POTENTIAL EFFECTS ON THE OIL AND GAS INDUSTRY CONCERNING THE ENERGY PROVISIONS OF THE TREASURY TAX SIMPLIFICATION PROPOSAL

FROM: MARK A. STANSBERRY

FEBRUARY 15, 1985

WM. V. (BILL) HARRIS, PRESIDENT
FIRST NATIONAL BANK & TRUST COMPANY, ENID, OKLAHOMA

"THE EFFECTS WOULD BE DEVASTATING. AS WE ARE TRYING TO SLOWLY WORK OURSELVES OUT OF THE PROBLEMS AND THE DOWNTURN IN THE OIL AND GAS INDUSTRY THAT WOULD JUST STOP ANY HOPE OF RECOVERY THAT WE HAVE. EVEN IF YOU ARE NOT IN THE OIL BUSINESS, IT IS GOING TO TAKE ITS MAJOR TOLL ON THE COMMUNITY."

JERALD STRINGER, PRESIDENT
BANK OF WESTERN OKLAHOMA, ELK CITY, OKLAHOMA

"IT WILL BURY THE OIL AND GAS INDUSTRY. WHY SHOULD THE OIL AND GAS BUSINESS BE DIFFERENT FROM ANY OTHER BUSINESS? THE ACTUAL EXPENSES IN DRILLING A WELL SHOULD BE DEDUCTED DURING THE CURRENT PERIOD."

JOHN S. MCMILLIN, PRESIDENT
ELK CITY STATE BANK, ELK CITY, OKLAHOMA

"IT WILL BRING INDEPENDENTS TO THEIR KNEES AND ALL RELATED COMPANIES TO THEIR KNEES. THE BOARD IS STRONGLY OPPOSED. THE GENERAL ECONOMY OF ELK CITY WILL COME TO A SCREECHING HALT BECAUSE THERE WON'T BE ANY MORE EXPLORATION."

BILL NICHOLS, PRESIDENT
FIRST NATIONAL BANK, CORDELL, OKLAHOMA

"WE ARE AGAINST THE REPEAL OF THE INTANGIBLE DRILLING COSTS AND DEPLETION ALLOWANCE TAX. WE ARE HOPEFUL THAT BOTH THE IDCS AND DEPLETION ALLOWANCE WILL REMAIN INTACT."

G.W. LOWRY, JR., PRESIDENT
OKLAHOMA BANK AND TRUST COMPANY
CLINTON, OKLAHOMA

"THERE IS NO QUESTION THAT IT WOULD HURT OKLAHOMA, FOR THAT MATTER ALL ENERGY RELATED STATES, AND IN TURN ALL THE COUNTRY."

DURANT MCINNIS, PRESIDENT
CITY NATIONAL BANK AND TRUST COMPANY
GUYMON, OKLAHOMA

"ALL THE ECONOMY DEPENDS UPON A STRONG ENERGY MARKET. WE MUST DO WHAT WE CAN TO DEFEAT THE TREASURY'S PROPOSAL."

JOHN LOEWEN
THE FIRST NATIONAL BANK, HENNESSEY, OKLAHOMA

"THE REPEAT OF THE IDC AND DEPLETION ALLOWANCE ITEMS WOULD HAVE CRIPPLING EFFECTS. IT WOULD DEFINITELY SHOOT OUR ECONOMY DOWN."

BOB SHARP, BUSINESSMAN

"MIGHT AS WELL SHUT THE DOORS. THERE IS NO USE IN SHUTTING DOWN OKLAHOMA AND ALL THE ENERGY STATES TO TRY AND SAVE THE REST OF THE COUNTRY."

STANLEY NIECE, ATTORNEY

"IF YOU DO AWAY WITH INTANGIBLE DRILLING COSTS AND DEPLETION ALLOWANCE AND TAX THE ENERGY INDUSTRY FURTHER, IT SEEMS WE WILL BECOME MORE DEPENDENT ON FOREIGN OIL. I ASK THAT OUR INTEREST BE PROTECTED."

BRUCE T. BENBROOK, PRESIDENT
THE STOCK EXCHANGE BANK
WOODWARD, OKLAHOMA

"THE OIL AND GAS INDUSTRY HAS HAD ENOUGH PROBLEMS. THE ENERGY MARKET WILL NOT ONLY SUFFER BUT THE LOCAL, STATE AND NATIONAL ECONOMIES WILL SUFFER AS WELL."

WENDELL POWELL, INVESTOR

"HOW DOES THE CONGRESS INTEND TO TAX OTHER BUSINESSES IN REGARD TO THEIR EXPENSES? IF LABOR EXPENSES, MATERIAL EXPENSES, AND OTHER COSTS ARE LEGITIMATE EXPENSES FOR SOME BUSINESSES AND NOT FOR OTHERS, THEN THERE IS NO FAIRNESS TO OUR SYSTEM. WE NEED TO STRUCTURE A FAIR TAX PROGRAM."

DON M. KELLEY, PRESIDENT
FIRST NATIONAL BANK, WEATHERFORD, OKLAHOMA

"IT IS COMPLETELY RIDICULOUS. THEY ARE CALLING IT INTANGIBLE DRILLING COSTS AND THAT IS THE WRONG NAME. THEY NEED TO CALL IT LEGITIMATE BUSINESS EXPENSES. DO YOU WANT US TO STOP DEDUCTING LEGITIMATE BUSINESS EXPENSES? ARE YOU GOING TO STOP ALL BUSINESSES FROM DEDUCTING THEIR SALARIES AND EXPENSES?"

W.A. MYERS, JR., PRESIDENT
CENTRAL NATIONAL BANK, ALVA, OKLAHOMA

"IT WOULD BE RIDICULOUS TO TRY TO CHANGE FROM WHAT IT IS NOW."

CLINTON PARR, BUSINESSMAN

"IT WILL NOT ONLY AFFECT A LOCAL AREA, BUT THE STATE OF OKLAHOMA, COUNTRY, AND THEN WE COULD BE HELD HOSTAGE AGAIN BY INTERNATIONAL MARKETS."

THE TREASURY DEPARTMENT'S PROPOSED ENERGY TAX PLAN WOULD BE DETRIMENTAL TO THE ENERGY INDUSTRY AND TO THE NATION AS A WHOLE. THE PLAN, IF IMPLEMENTED, COULD DESTROY OUR FREEDOM AND OUR SECURITY.

BOTH AS A BANKER AND AS AN OIL AND GAS INVESTOR, I AM DISTURBED THAT SUCH A PROPOSAL IS EVEN BEING DEBATED. THERE IS NO DOUBT IN MY MIND THAT BOTH THE FINANCIAL MARKET AND THE ENERGY INDUSTRY WILL GREATLY SUFFER IF THE PROPOSAL IS ENACTED.

THE TREASURY'S ENERGY TAX IDEA ALONE HAS CAUSED MANY OIL AND GAS INVESTORS AND COMPANIES TO AWAIT A DECISION. THE OIL AND GAS INDEPENDENT, ON THE ONE HAND, IS HIGHLY CONCERNED ABOUT THE NECESSARY FUNDING, WHILE ON THE OTHER HAND, THE INVESTOR IS HESITANT ABOUT INVESTING HIS MONEY UNTIL CONGRESS TAKES A STAND. THEREFORE, OUR LOCAL ECONOMY AND STATE ECONOMY COME TO A STANDSTILL.

THE FINANCIAL INSTITUTIONS AND THE ENERGY INDUSTRY ARE NOT THE ONLY ONES TO BE AFFECTED IF THE INTANGIBLE DRILLING COSTS AND DEPLETION ALLOWANCE ARE REPEALED. FOR INSTANCE, JOHN O'HARA, A RETIRED WESTERN OKLAHOMA FARMER, STATES THAT "IF THE OIL AND GAS INDUSTRY GETS HURT THAT BADLY THEY ARE NOT GOING TO DO ANY DRILLING, ANY EXPLORING, OR ANY LEASING. AND IF IT WASN'T FOR THE OIL AND GAS LEASE MONEY, THE FARMERS IN THIS AREA WOULD HAVE IN LARGE NUMBERS GONE BANKRUPT." MIKE JACKSON, A WESTERN OKLAHOMA BUSINESSMAN, STATES "FROM OUR STANDPOINT, A GREAT DEAL OF OUR BUSINESS IS OIL AND GAS RELATED.

IF THEY CURTAIL DRILLING ANY MORE, WE ARE LOOKING AT THE CLOSING OF A GREAT PERCENTAGE OF OUR BUSINESSES IN WESTERN OKLAHOMA". DONALD ROYSE, A WESTERN OKLAHOMA ATTORNEY AND ROYALTY OWNER, PROCLAIMS "WE HAVE TO KEEP THE OIL AND GAS INDUSTRY ACTIVE. ANYTHING THAT IMPEDES DRILLING AND EXPANSION WILL SLOW DOWN THE WHOLE ECONOMY." IN A CONVERSATION WITH DR. J. TERRY JOHNSON, PRESIDENT OF OKLAHOMA CHRISTIAN COLLEGE, WE DISCUSSED THE CONCERN OVER THE FACT THAT HIGHER EDUCATION SUFFERS WHEN THE ECONOMY SUFFERS. THAT IF THE ENERGY INDUSTRY IS BURDENED THEN OKLAHOMA'S HIGHER EDUCATION LOSES.

DURING THE LAST OIL AND GAS BOOM, ELK CITY, OKLAHOMA ENJOYED THE INCREASE IN POPULATION AND IN THE OVERALL ECONOMY. THOUGH ELK CITY AND OTHER WESTERN OKLAHOMA COMMUNITIES DO NOT EXPECT SUCH BOOM TIMES IN THE NEAR FUTURE, WE ARE HOPEFUL THAT OUR ECONOMY WILL NOT HAVE ANY MORE DRASTIC DOWNTURNS.

ENCLOSED IN MY REPORT ARE FIGURES AND CHARTS PROVIDED BY WAYNE MACKLEY, MANAGER OF THE ELK CITY CHAMBER OF COMMERCE, WHICH DISPLAYS A TYPICAL WESTERN OKLAHOMA TOWN'S ECONOMY OVER THE PAST FEW YEARS. THE DOWNTURN IN THE ANNUAL SALES TAX RECEIPTS AND CITY'S ACTIVE WATER METERS AT YEAR END SHOWS TREMENDOUS LOSSES WHICH MEANS MORE UNEMPLOYMENT AND A WEAKENING IN OUR LOCAL ECONOMIES.

FINANCIAL INSTITUTIONS IN WESTERN OKLAHOMA OPPOSE THE REPEAL OF INTANGIBLE DRILLING COSTS AND DEPLETION ALLOWANCE. PHIL KLIEWER, PRESIDENT OF THE CORDELL NATIONAL BANK, CORDELL, OKLAHOMA COMMENTS "THAT THE IDC AND DEPLETION ALLOWANCE ISSUE WOULD BE DEVASTATING NOT ONLY TO OUR DIRECT ENERGY RELATIONSHIPS, BUT ALSO TO ALL THE ENERGY RELATED COMPANIES SUCH AS SERVICE COMPANIES THAT ARE TIED TO THE INDEPENDENTS. THEY WOULD BE COMPLETELY WIPED OUT. WE DEFINITELY WOULD FEEL THE REPERCUSSIONS THROUGH THE DOMINO EFFECT." JOE WILLIAMS, PRESIDENT OF THE AMERICAN HERITAGE BANK IN EL RENO, OKLAHOMA EXPLAINS "WE DEFINITELY DO NOT NEED TO STOP THE OIL AND GAS EXPLORATION AT THIS CRITICAL TIME. REPEAL OF THE IDC AND DEPLETION ALLOWANCE WOULD ONLY ENCOURAGE MORE FOREIGN IMPORTS AND THEREFORE CREATE DRASTIC ECONOMIC PROBLEMS FOR OUR COUNTRY. THE ENERGY MARKET IS BEING SINGLED OUT AND IS ALREADY IN DEEP TROUBLE."

MOST IMPORTANTLY, THE OIL AND GAS INDUSTRY MUST NOT COUNTER ANY MORE PROBLEMS. AS A STUDY PREPARED BY THE COLLEGE OF BUSINESS ADMINISTRATION DEPARTMENT AT OKLAHOMA STATE UNIVERSITY, WHICH IS A PART OF THIS REPORT, POINTS OUT THAT "WITH A PESSIMISTIC PICTURE FOR ENERGY PRICES, NO SIGNIFICANT GROWTH CAN BE EXPECTED IN 1985 FOR RIG ACTIVITY OR WELL COMPLETIONS." COMPOUNDED WITH THE FACT THAT IF THE IDC AND DEPLETION ALLOWANCE ARE REPEALED, THEN THE AMERICAN OIL AND GAS INDUSTRY FALLS.

EDWARD H. LEEDE OF LEEDE EXPLORATION, MIDLAND, TEXAS, EXPLAINED TO ME THAT "WE DO NOT NEED ANYTHING ELSE THAT MAKES IT MORE DIFFICULT FOR US TO HELP MAINTAIN OUR ENERGY RESERVES IN THIS COUNTRY. THERE IS NO DOUBT, THAT THE WORST THING WOULD BE THE REMOVAL OF THE INTANGIBLE DRILLING EXPENSE ITEM AND ALMOST AS BAD IS THE DEPLETION ITEM WHICH IS IMPORTANT TO

INDEPENDENTS WHO FIND SO MUCH OF THE NEW OIL AND GAS. THERE WOULD BE A REDUCTION IN DRILLING AT A TIME WE DON'T NEED IT. WE DO HAVE AN OVER DELIVERABILITY OF GAS RIGHT NOW BUT BEFORE TOO LONG, THOUGH WE DON'T KNOW THE TIME FRAME, THERE IS GOING TO BE A TURNAROUND AND A SITUATION AGAIN WHERE WE WILL HAVE A SHORTAGE. THE STRONGER THE DOMESTIC INDUSTRY IS, THE LESS WE HAVE TO RELY UPON UNCERTAIN IMPORTS. IT IS DISASTROUS WHAT IT CAN DO TO THE OIL AND GAS BUSINESS." AND ONLY TWO DAYS AGO, JAYE F. DYER, PRESIDENT AND CEO OF DYCO PETROLEUM CORPORATION, MINNEAPOLIS, MINNESOTA, MAKES THE FOLLOWING OBSERVATIONS FOR THIS REPORT: "OUR PRIMARY AREA OF INTEREST AND PRIMARY AREA OF DRILLING ACTIVITY IS THE ANADARKO BASIN IN WESTERN OKLAHOMA AND THE TEXAS PANHANDLE. WE ARE DEEPLY CONCERNED BY THE AFFECT OF THE PROPOSED TREASURY'S TAX REFORM PACKAGE WILL HAVE ON OUR BUSINESS SPECIFICALLY IN THE LOSS OF THE INTANGIBLE DRILLING COSTS AND THE DEPLETION ALLOWANCE. DYCO PETROLEUM IS A PROGRAM COMPANY. WE IN 1980 COMMISSIONED AN INDEPENDENT CONSULTANT IN WASHINGTON, D.C. TO DO AN ANALYSIS OF OUR PUBLIC DRILLING PROGRAMS AND THEIR RATES OF RETURN WITH FULL TAX BENEFITS AND THEN WITHOUT THE INTANGIBLE DRILLING COSTS AND DEPLETION ALLOWANCE. WHAT WE FOUND AND WHAT WE LEARNED, BOTTOM LINE, WAS THAT THE AVERAGE INTERNAL RATE OF RETURN FOR OUR PROGRAMS FROM 1971 THROUGH 1977 WAS RIGHT AROUND 21%. THEN RUNNING THOSE SAME PROGRAMS THROUGH THE MODEL AGAIN WITHOUT THE DEPLETION ALLOWANCE THE INTERNAL RATE OF RETURN FOR THOSE PROGRAMS ON AVERAGE FELL TO AROUND 12%. THEN WITHOUT THE INTANGIBLE DRILLING COSTS THAT RATE OF RETURN FALLS TO AROUND

10%. IF YOU DELETE OR TAKE AWAY THE TAX BENEFITS DERIVED FROM INTANGIBLE DRILLING COSTS AND THE DEPLETION ALLOWANCE THE INTERNAL RATE OF RETURN FOR THOSE PROGRAMS OF OURS FALLS TO AROUND 4%. SO WITH EXISTING TAX TREATMENT YOU HAVE A VERY COMPETITIVE INVESTMENT WHICH ADDS A LOT OF CAPITAL TO THE EXPLORATION INDUSTRY. WITHOUT THE BENEFIT OF THE TAX ADVANTAGES, THAT SOURCE OF CAPITAL WILL DRY UP BECAUSE THE INVESTMENT CAN NO LONGER BE COMPETITIVE. SO FROM OUR VERY NARROW PERSPECTIVE TO A MORE NATIONAL PERSPECTIVE, IT DOES NOT SEEM LOGICAL TO US THAT IN THIS DAY AND AGE WHEN ENERGY SECURITY SHOULD BE IN THE FOREFRONT OF OUR MINDS, WE ARE FACED WITH A PROPOSAL WHICH WILL ONLY SERVE TO DRASTICALLY REDUCE DOMESTIC DRILLING ACTIVITY AND IN TURN JEOPARDIZE ANY TYPE OF NATIONAL SECURITY OBJECTIVES WE MAY HAVE. THE TAX INCENTIVES ARE ESSENTIAL TO CAPITAL FORMATION IN THE OIL AND GAS BUSINESS AND ESSENTIAL TO THE SMALL INDEPENDENT PRODUCERS LIKE OURSELVES."

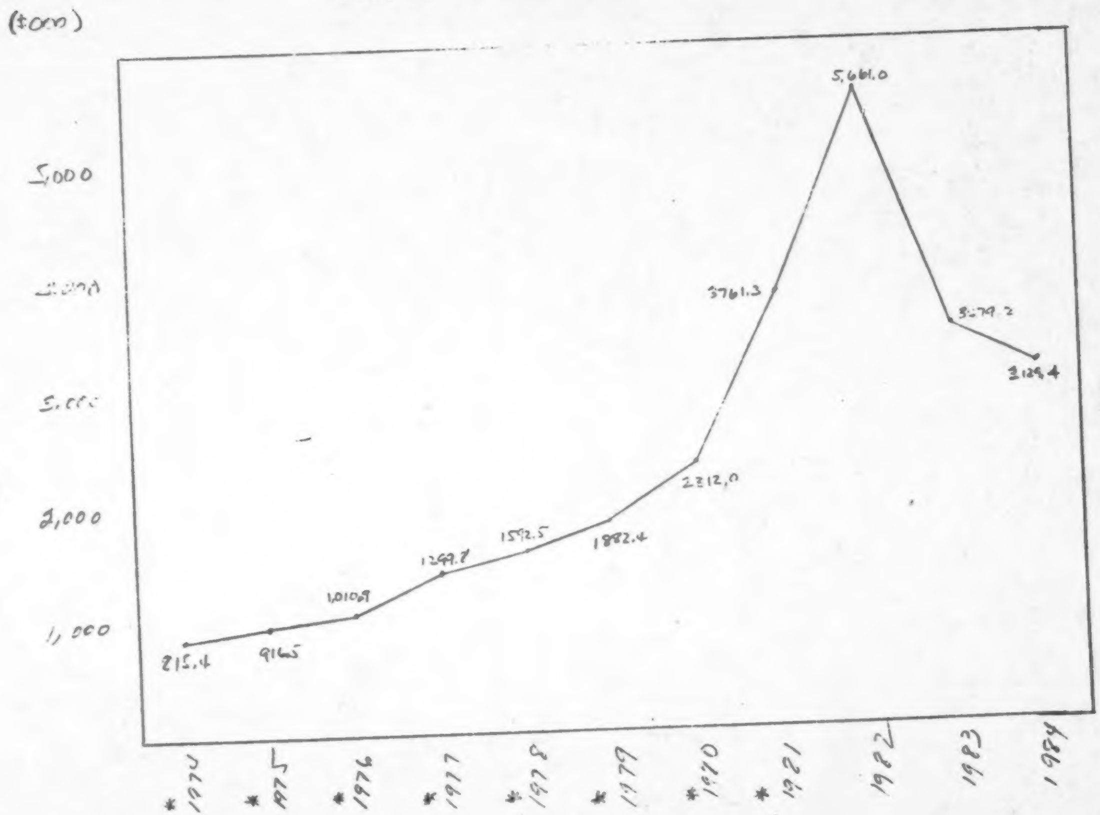
INCLUDED IN MY REPORT ARE EXTRACTS FROM THE TEXAS RAILROAD COMMISSIONS'S 1983 REPORT TELLING A CHILLING STORY AND FACTUAL ONE NOTING THE FACT THAT IN TEXAS THE GAS RESERVES ARE 60% LESS THAN FIFTEEN YEARS AGO, AN ARTICLE ENTITLED "NINE DAYS ON THE BRINK" WRITTEN BY JAMES E. NUGENT OF THE TEXAS RAILROAD COMMISSION, UPDATED CHARTS PROVIDED TO ME BY W.J. (BILL) MURRAY, JR. WHO FORMERLY SERVED ON THE TEXAS RAILROAD COMMISSION AND IS NOW AN ENERGY CONSULTANT, ALSO, A COPY OF HIS SPEECH DELIVERD LAST SUMMER IN SAN DIEGO, CALIFORNIA BEFORE THE INTERSTATE COMPACT COMMISSION, AN ARTICLE WRITTEN BY MACK WALLACE, A SENIOR MEMBER OF THE TEXAS RAILROAD COMMISSION AND OTHER STATEMENTS MADE BY CONCERNED BANKERS AND CITIZENS.

CITY of ELK CITY
ANNUAL SALES TAX RECEIPTS

YEAR	RECEIPT ($000)	PREVIOUS YEAR ($000)	LOSS FROM PREVIOUS YEAR ($000)
*1974	815.4		
*1975	916.5	101.1	
*1976	1,010.9	94.4	
*1977	1,299.8	288.9	
*1978	1,592.5	292.7	
*1979	1,882.4	289.9	
*1980	2,312.0	429.6	
*1981	3,761.3	1,449.3	
1982	5,661.0	1,899.7	
1983	3,479.2		2,181.8
1984	3,129.4		349.8

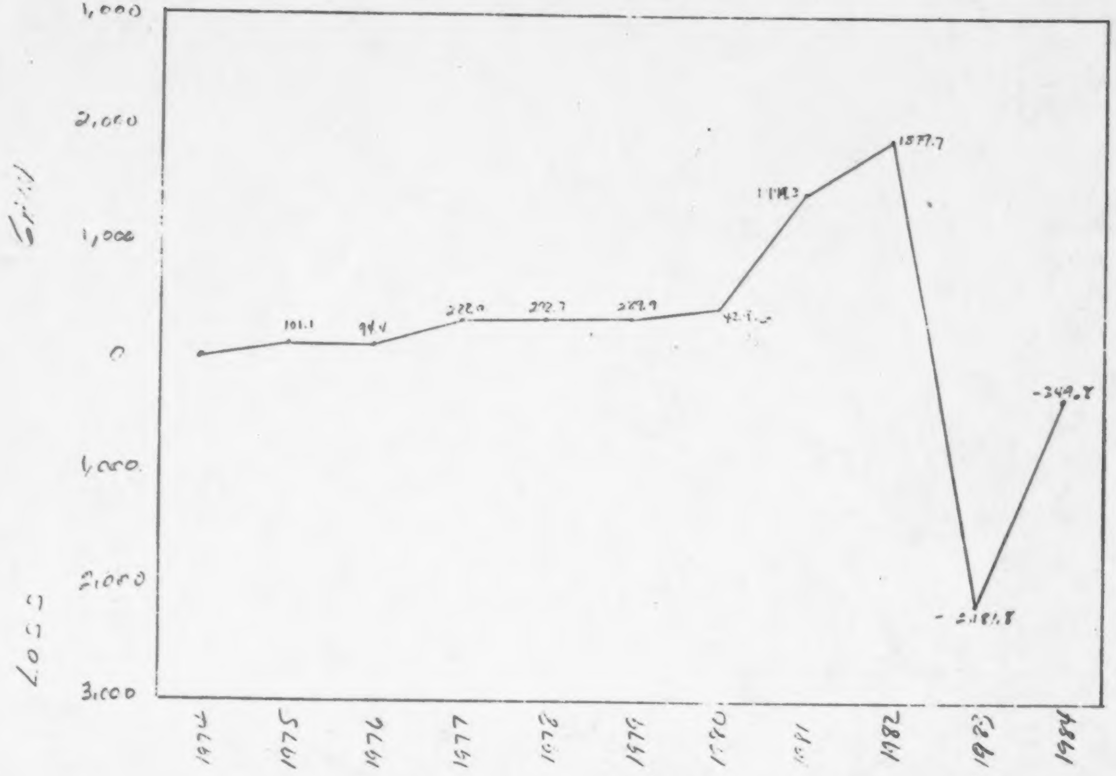
*Adjusted to reflect a constant 3% tax rate.

City of Elk City
Sales Tax Receipts



* adjusted to reflect a constant 3% tax rate

City of Elk City
Net Gain or Loss
Sales tax Receipts



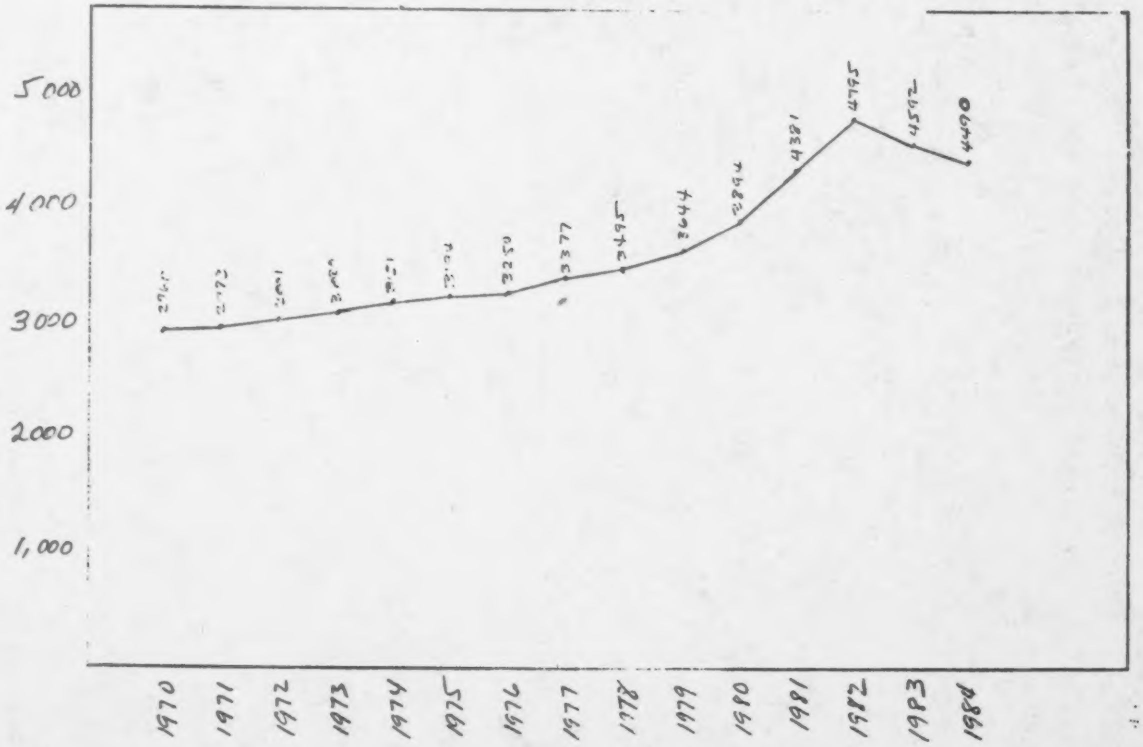
CITY of ELK CITY

Active Water Meters at Year End

YEAR	NUMBER	GAIN OR LOSS FROM PREVIOUS YEAR	
		GAIN	LOSS
1970	2960	67	
1971	2983	23	
1972	3001	18	
1973	3080	79	
1974	3151	71	
1975	3194	43	
1976	3250	56	
1977	3377	127	
1978	3495	118	
1979	3644	149	
1980	3894	250	
1981	4381	487	
1982	4795	414	
1983	4592		203
1984	4490		102

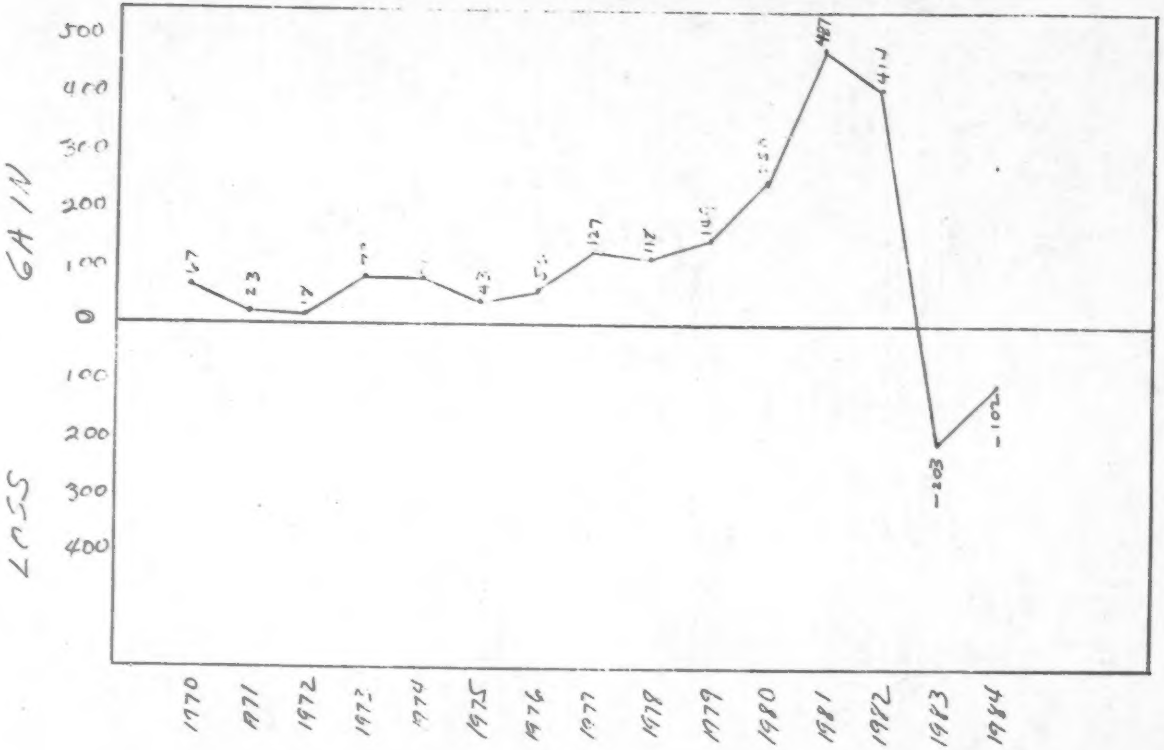
CITY of ELK CITY

Active Water Meter Connections
AT YEAR END



CITY of ELK CITY

Net GAIN or Loss of Active Water Meters
YEAR end to YEAR end



ENERGY

With a pessimistic picture for energy prices, no significant growth can be expected in 1985 for rig activity or well completions.

No one in Oklahoma needs to be reminded any longer that oil and gas activities have significant effects beyond the direct impacts of exploration and extraction. There are strong linkages between this sector and other state industries. Although actual employment in the mining sector accounts for only about 6.5 percent of the state's nonagricultural employment, many additional workers are employed by directly related refining, machinery, manufacturing, pipeline, service, rental, repair, leasing, legal, and trading activities. If the additional indirect impacts generated by energy industry purchasing through supply linkages and worker expenditures in the consumption sector are added, it is estimated that over one-fifth of Oklahoma's nonagricultural employment is either directly or indirectly tied to the broadly-defined energy industry.

Not only is the energy industry important in Oklahoma, it is also the source of much of the rapid growth and decline the state has experienced in recent years. Wide fluctuations in the prices of oil and natural gas have been the principal cause of the rapid and large movements of this industry sector. Average prices for the total oil production of Oklahoma rose from $11.50 per barrel in FY 1979 to $32.00 in just two years. Average prices for total natural gas production rose from $0.97 per thousand cubic feet in FY 1979 to $2.36 in just three years. With expectations for the future high and rising, it is little wonder that the average number of active drilling rigs in the state rose to nearly 700 in 1981, compared to just under 400 the previous year. Production levels of oil and gas also responded in the 1980-1982 period, but with quantity increases in the neighborhood of only 4.0 to 8.0 percent.

The year 1982, known as the year of collapse in the industry, was actually a mixture of deep decline in oil exploration and continued advance for natural gas prices and well drilling. Thus, average industry figures for 1982 are somewhat misleading.

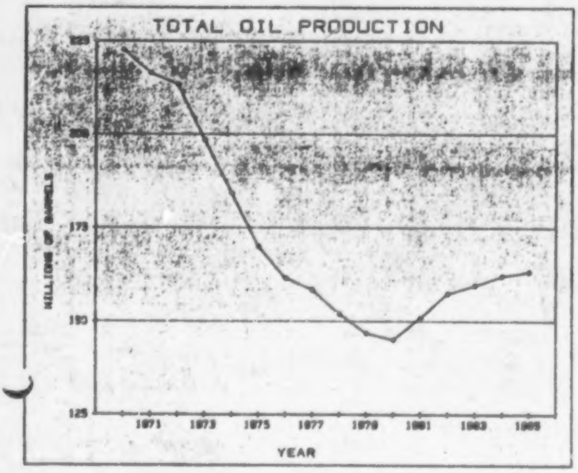
Information for 1983 that was recently released indicates that fewer wells were drilled in 1983 than in 1982 for both gas and oil. The values of crude oil and natural gas production were very similar in Oklahoma at just under $5 billion, but the average annual price rose for natural gas to $2.70/mcf and declined for crude oil to $31.38/barrel. Preliminary data for the first three quarters of 1984 indicate that the rig count and number of permits have improved somewhat, but wells completed are about the same as the corresponding period of the year earlier. Average annual prices of total production, however, appear to have declined in Oklahoma for both oil and gas.

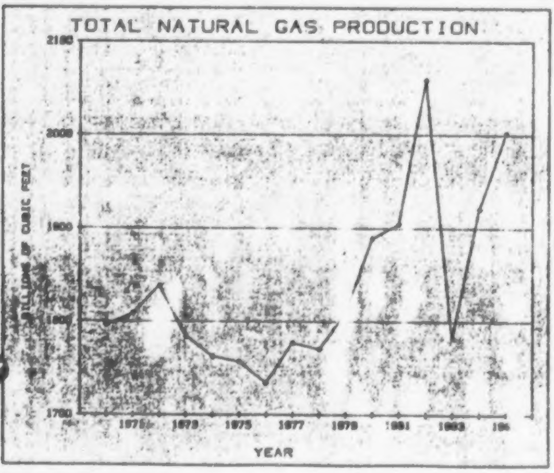
Energy sector forecasts for 1985 are, of course, heavily dependent on price assumptions for national and international markets as well as the overall level of economic activity. Conditions are once again uncertain with supply problems of OPEC and other oil producers as well as with potential impacts of natural gas price deregulation scheduled for January 1, 1985, and export policy changes of our gas-producing neighbors. Nevertheless, projections of U.S. oil prices that are nearly constant in nominal dollars and a wellhead gas price increase of 1.9 percent are used in this analysis. After accounting for the effects of inflation, these price assumptions indicate declines in the real prices of oil and natural gas.

With this rather pessimistic picture for prices, no significant growth can be expected in 1985 for rig activity or well completions. Some small growth (under 1.0 percent) may occur in the number of total producing wells, and output levels should remain in the neighborhood of 163 million barrels of oil and 2.0 trillion cubic feet of natural gas.

Should petroleum prices fall substantially, the Oklahoma economy would be affected by two strong but opposing forces. The direct impact on the energy sector in Oklahoma would be substantially lower growth (or absolute declines) in mining employment, rig activity, and producing wells along with the loss of gross production taxes and other government revenues. The national economy, however, would benefit from lower inflation, more real output and employment, improvement in the balance of payments, and, possibly, lower interest rates. The pass-through consequences in Oklahoma, according to analyses using the forecasting model, would stimulate nonoil related activity, primarily in manufacturing and closely associated sectors. Nevertheless, the net effects still appear to be dominated by the energy sector, leaving lower personal incomes and state government tax revenues and higher unemployment in the wake.

Forecasts of energy consumption in Oklahoma are also affected by price changes and economic activity levels as well as such uncontrollables as weather conditions. Electricity sales in the various categories are expected to grow by rates in the 2.0-3.0 percent range with residential sales showing the largest increase. Natural gas consumption is typically somewhat more volatile and may be especially so in 1985 as partial deregulation is implemented. Most categories of sales, however, are expected to show very small demand increases over year-earlier levels.





1985 FORECAST

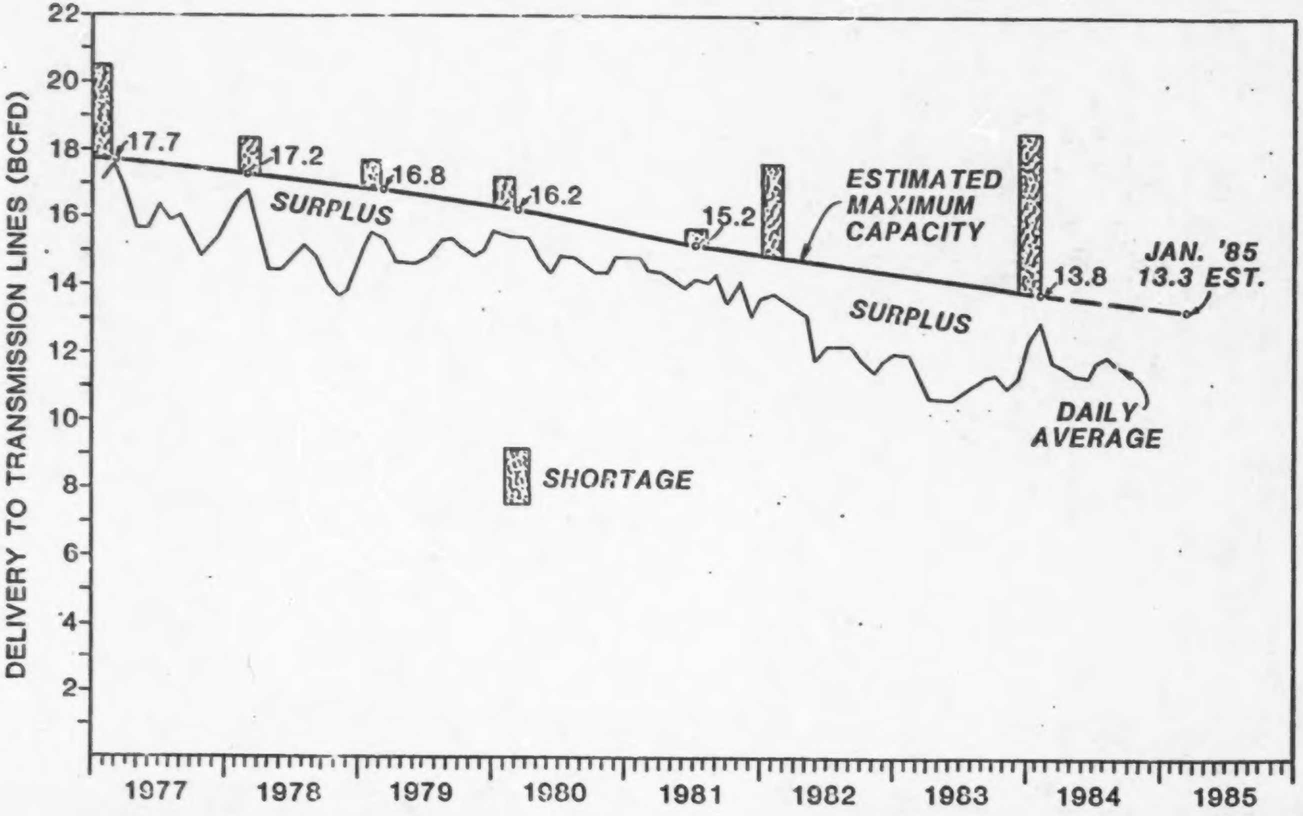
Total oil production will reach **163.3 MILLION** barrels and total natural gas production will exceed **2.0 TRILLION** cubic feet

Energy Production

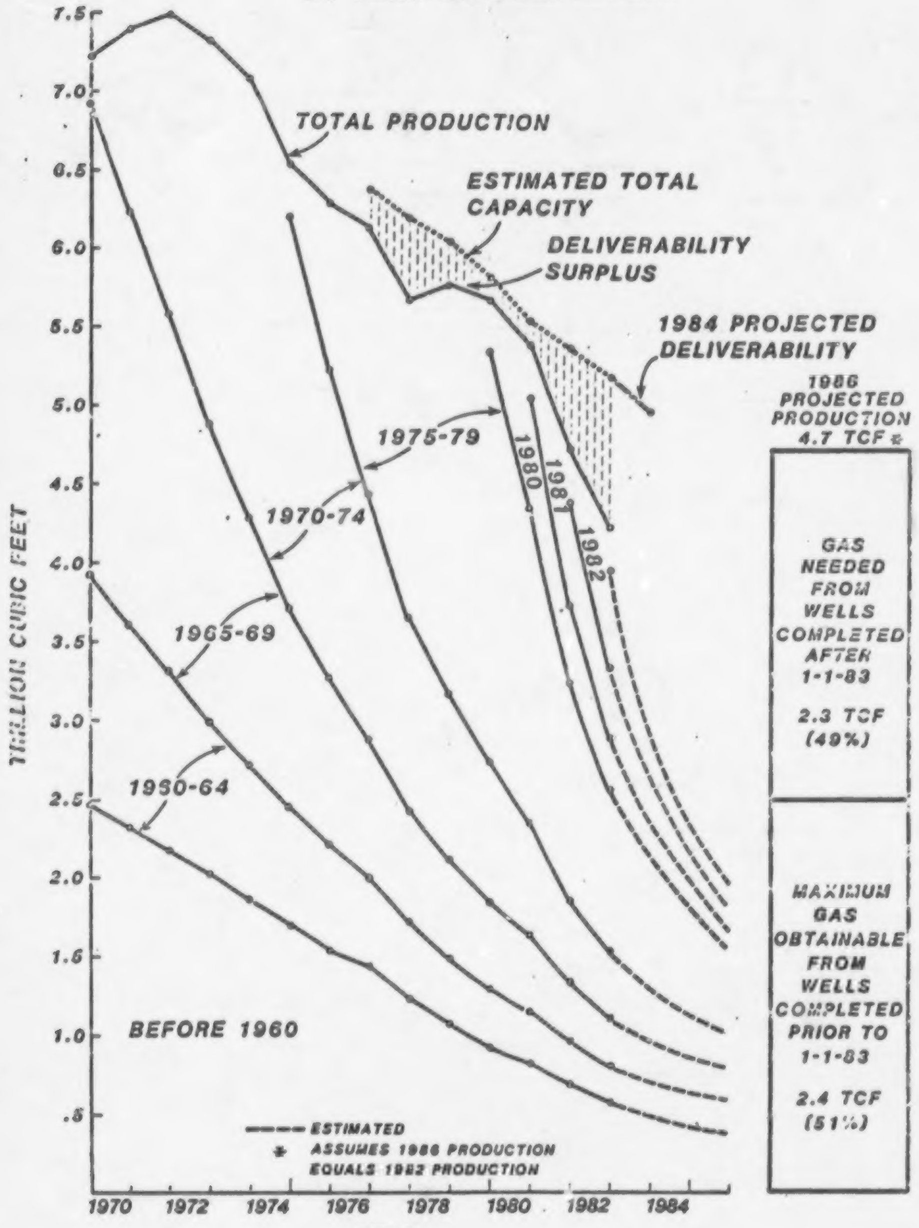
Total Oil Production (growth rate)	163.3 million barrels 0.7%
Total Natural Gas Production (growth rate)	2001.6 billion cubic feet 4.2%

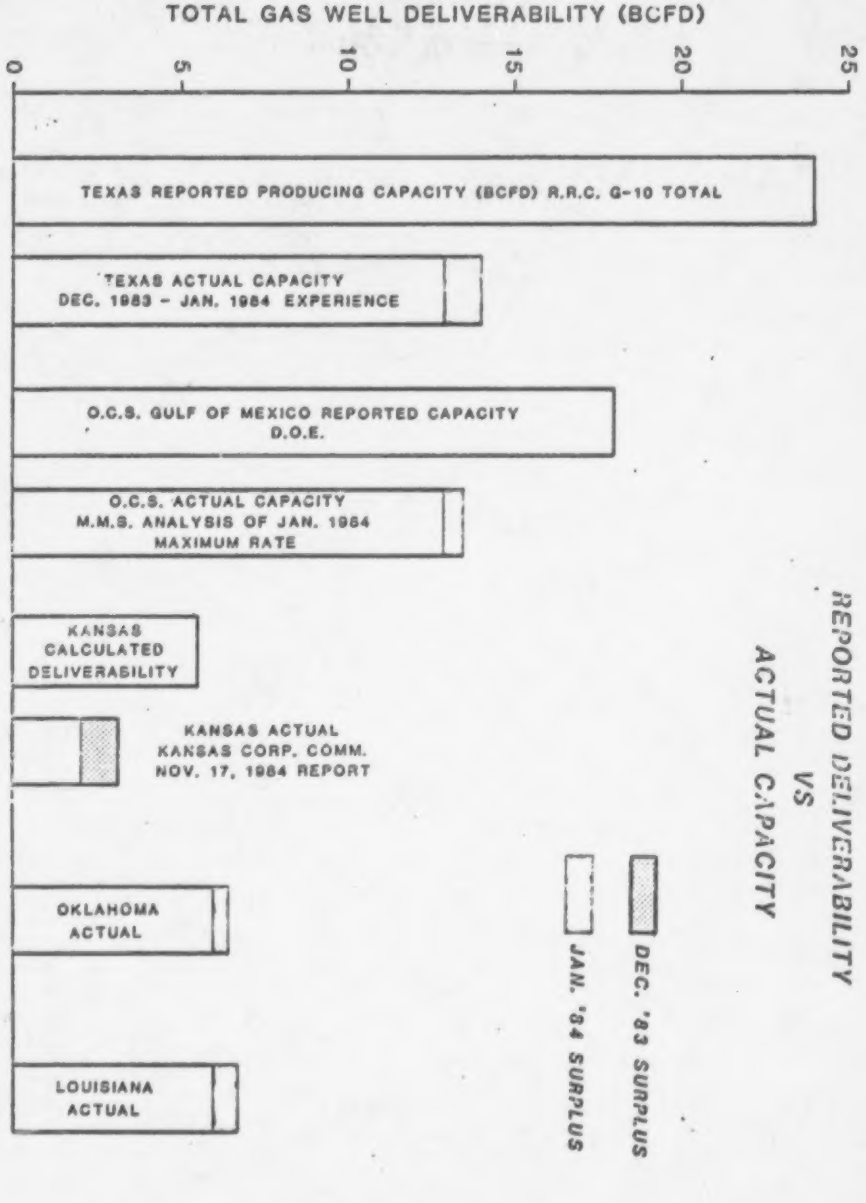
Energy Consumption	Trillions of BTUs	Growth Rate
Natural Gas Sales	432.2	2.9%
Residential	82.8	0.1
Commercial	48.5	3.9
Industrial and Other	300.9	3.5
	Millions of KWHs	Growth Rate
Electricity Sales	39,701	2.5%
Residential	14,732	2.9
Commercial	10,100	2.2
Industrial and Other	14,869	2.4

TEXAS NATURAL GAS-CAPACITY vs DEMAND

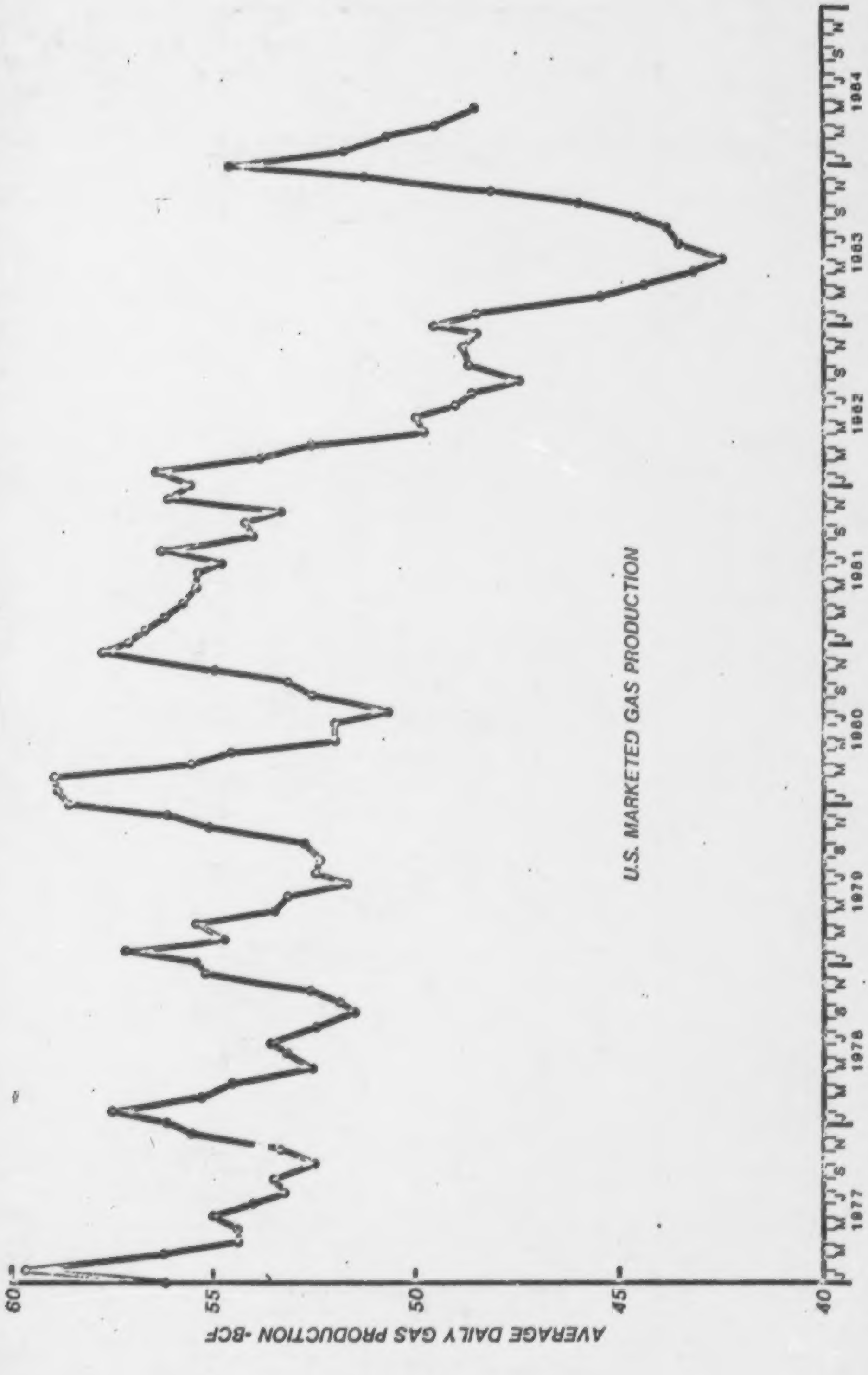


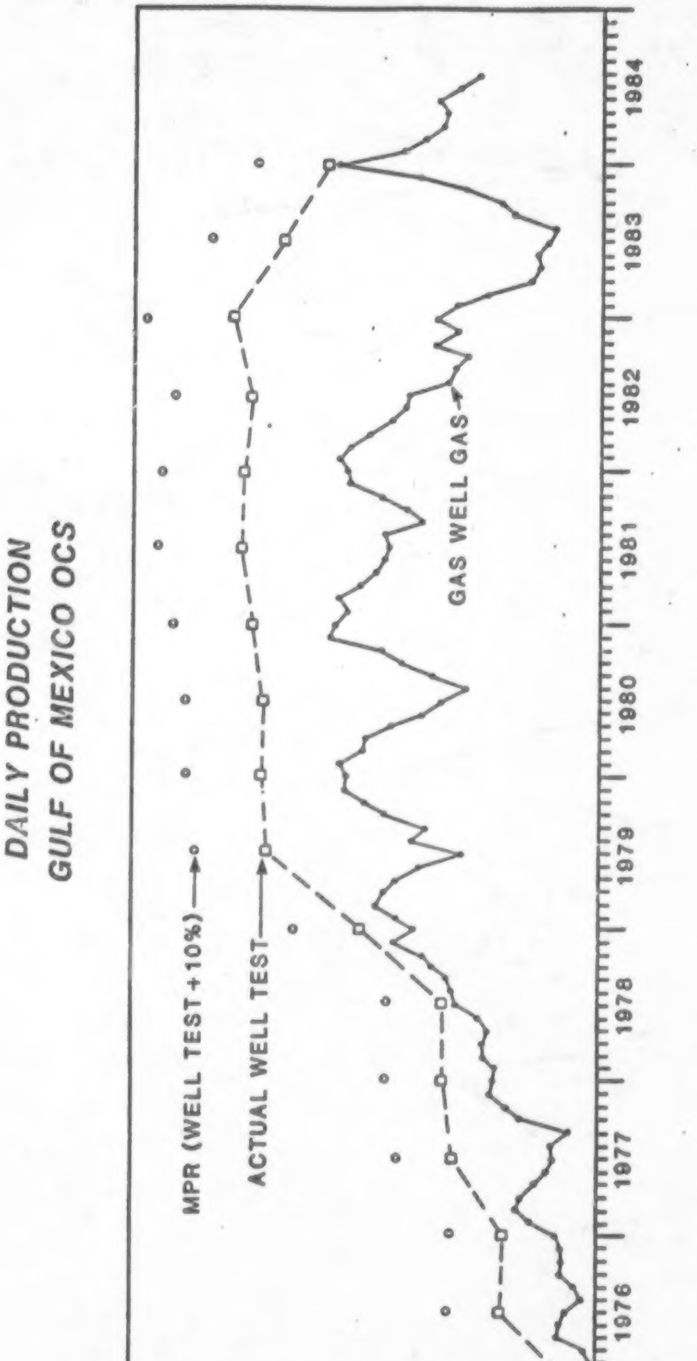
TEXAS GAS WELL PRODUCTION BY YEAR OF COMPLETION





REPORTED DELIVERABILITY VS ACTUAL CAPACITY


U.S. MARKETED GAS PRODUCTION
AVERAGE DAILY GAS PRODUCTION -BCF
60
55
50
45
40
1977
1978
1979
1980
1981
1982
1983
1984


DAILY PRODUCTION
GULF OF MEXICO OCS
NATURAL GAS
BILLION CUBIC FEET
17
16
15
14
13
12
11
10
9
1976
1977
1978
1979
1980
1981
1982
1983
1984
MPR (WELL TEST + 10%)
ACTUAL WELL TEST
GAS WELL GAS

Oil and Gas Division

Annual Report

1983

RAILROAD COMMISSION OF TEXAS

Mack Wallace, Chairman
Buddy Temple, Commissioner
James E. (Jim) Nugent, Commissioner

TABLE 1
HISTORY OF TEXAS CRUDE OIL RESERVES, PRODUCTION AND NUMBER OF PRODUCING WELLS

	CRUDE OIL		
Year at January 1	(M Barrels) Estimated Proven Reserves* of Crude Oil at January 1	(M Barrels) Total Crude Oil Production** for Year	No. Crude Oil Producing Wells End of Year
1935	5,500,000	375,617	59,461
1936	6,010,000	418,776	68,054
1937	6,422,000	506,067	77,565
1938	8,247,928	468,782	85,137
1939	9,447,764	476,550	89,914
1940	9,768,371	486,662	95,214
1941	10,623,515	499,208	98,802
1942	10,975,641	477,828	98,757
1943	11,545,727	587,436	98,596
1944	11,324,954	741,126	99,746
1945	10,835,257	751,045	101,225
1946	11,470,294	755,900	103,109
1947	11,646,360	816,188	105,537
1948	11,777,537	898,314	109,643
1949	12,484,218	736,627	115,483
1950	13,509,732	817,842	123,271
1951	13,581,642	991,983	130,309
1952	15,314,964	1,009,793	136,398
1953	14,916,168	1,000,545	142,159
1954	14,998,620	954,434	149,142
1955	14,982,003	1,002,480	158,598
1956	14,933,502	1,078,886	168,930
1957	14,783,139	1,057,997	176,705
1958	14,555,140	909,958	182,633
1959	14,322,216	944,410	188,934
1960	14,859,674	892,084	192,627
1961	14,758,492	894,765	196,396
1952	14,849,574	894,023	197,659
1963	14,648,325	915,420	198,236
1964	14,573,125	928,606	199,119
1965	14,299,847	932,810	197,924
1966	14,303,058	1,000,325	196,308
1967	14,077,134	1,073,848	192,100
1968	14,494,109	1,087,825	187,681
1969	13,809,906	1,107,146	183,141
1970	13,063,182	1,207,625	177,221
1971	13,195,476	1,182,371	172,696
1972	13,023,529	1,263,412	167,233
1973	12,144,057	1,257,057	159,090
1974	11,756,613	1,225,166	159,702
1975	11,001,506	1,185,683	160,603
1976	10,080,035	1,153,941	160,546
1977	9,226,250	1,101,137	163,746
1978	8,467,436	1,040,966	166,365
1979	7,689,991	978,544	169,826
1980	7,636,084	931,078	175,673
1981	8,206,000	897,573	183,991
1982	8,093,000	871,780	191,319
1983	7,616,000 - 49.73%	849,072	197,983

* *Estimated by American Petroleum Institute*
** *Railroad Commission of Texas*

TABLE 8

HISTORY OF TEXAS NATURAL GAS

Year	Total Number of Gas Wells	Number of Gas Wells Produced	Gas Well Gas Produced (MCF)	Casinghead Gas Produced* (MCF)	Total Gas Produced* (MCF)	Gas Reported as Vented or Flared* (MCF)	Natural Gas Reserves as of Jan. 1 (MMCF)
1936		2,717	575,275,000	269,463,000	844,738,000	100,786,000	
1937		2,943	658,713,000	335,175,000	993,888,000	91,341,000	
1938		3,158	705,908,000	393,367,000	1,099,275,000	137,196,000	
1939		3,246	872,286,000	442,773,000	1,315,059,000	142,403,000	
1940		3,403	1,087,089,000	452,238,000	1,539,327,000	132,740,000	
1941		3,553	1,382,830,000	427,462,000	1,810,292,000	101,147,000	
1942		3,685	1,508,794,000	402,328,000	1,911,122,000	81,988,000	
1943		3,800	1,683,920,809	438,647,209	2,122,568,018	91,121,000	
1944		3,962	1,907,704,332	527,013,593	2,434,717,925	111,563,000	
1945		4,658	2,065,266,423	599,911,322	2,665,177,745	119,048,103	
1946		5,122	2,098,867,220	664,545,023	2,763,412,243	108,484,579	78,306,676
1947	8,897	5,438	2,231,430,080	706,070,607	2,937,500,687	97,793,573	86,363,459
1948	9,440	5,570	2,540,917,386	707,303,721	3,248,221,107	102,422,509	90,025,566
1949	10,171	6,493	2,739,790,600	770,732,048	3,510,522,648	41,909,355	95,708,553
1950	10,807	7,310	3,099,606,096	924,570,897	4,024,176,993	28,424,156	99,170,403
1951	11,138	8,296	3,518,486,197	1,155,049,259	4,673,535,456	47,426,042	102,404,077
1952	12,136	9,202	3,779,106,990	1,310,269,791	5,089,376,781	184,423,922	105,653,229
1953	13,367	10,257	3,835,635,847	1,479,135,184	5,314,771,031	297,296,275	105,732,763
1954	14,608	11,224	3,955,492,811	1,555,169,157	5,510,661,968	255,273,285	106,529,626
1955	15,612	11,793	4,061,169,733	1,679,288,713	5,740,458,446	270,198,640	105,129,062
1956	17,339	12,503	4,196,274,738	1,808,459,532	6,004,734,270	268,225,365	108,287,548
1957	19,302	13,681	4,209,022,841	1,827,840,669	6,036,863,510	220,454,367	112,728,750
1958	21,335	15,349	4,383,259,164	1,666,868,115	6,050,127,279	161,881,612	113,084,518
1959	23,381	16,752	4,707,673,353	1,714,236,548	6,421,909,901	154,741,674	115,045,743
1960	25,807	18,612	5,017,874,190	1,657,295,605	6,675,169,795	131,208,550	120,475,783
1961	28,048	19,831	5,126,897,899	1,667,118,864	6,794,016,763	125,465,201	119,489,393
1962	29,541	20,834	5,258,336,700	1,647,302,820	6,905,639,520	129,150,927	119,838,711
1963	30,480	22,016	5,530,700,927	1,682,973,822	7,213,674,749	132,963,189	119,503,798
1964	32,416	22,995	5,846,879,988	1,707,287,547	7,554,167,535	117,475,433	117,809,376
1965	33,436	23,570	6,132,764,258	1,721,780,862	7,854,545,120	103,978,872	118,855,055
1966	34,521	23,716	6,258,199,039	1,839,765,501	8,097,964,540	110,245,344	120,616,760
1967	35,035	23,760	6,314,445,633	2,022,348,049	8,336,793,682	130,109,653	123,609,326
1968	35,459	23,805	6,512,818,553	2,100,053,643	8,612,872,196	125,264,469	125,415,064
1969	35,759	23,689	6,838,026,114	2,125,458,089	8,963,484,203	112,108,200	119,001,106
1970	35,749	23,417	7,204,522,710	2,245,335,308	9,449,858,018	100,852,690	112,392,622
1971	35,139	23,280	7,367,204,617	2,203,426,957	9,570,631,574	70,606,194	106,352,993
1972	35,231	23,373	7,450,363,616	2,152,266,013	9,602,629,629	60,147,987	101,472,108
1973	36,352	23,595	7,322,579,995	2,018,102,992	9,340,682,987	41,891,917	95,042,043
1974	37,243	24,635	7,068,268,065	1,839,160,750	8,907,428,815	34,619,921	84,936,502
1975	39,281	26,184	6,491,849,189	1,560,262,733	8,052,111,922	31,465,557	78,540,717
1976	41,657	28,026	6,247,330,373	1,460,988,470	7,708,318,843	30,568,194	71,036,854
1977	44,432	31,434	6,150,029,884	1,414,605,290	7,564,635,174	27,490,253	64,651,410
1978	47,516	33,157	5,690,601,922	1,386,498,376	7,077,100,298	25,695,711	62,157,836
1979	53,230	35,377	5,775,570,824	1,340,247,339	7,115,818,163	27,499,559	54,600,235
1980	55,909	37,345	5,675,595,010	1,322,296,207	6,997,891,217	28,993,837	51,610,771
1981	59,102	40,153	5,376,163,312	1,356,878,719	6,733,042,031	33,087,368	50,287,000
1982	62,768	42,772	4,721,572,710	1,392,277,794	6,113,850,504	33,241,660	50,469,000
1983	64,888	44,111	4,227,636,672	1,415,546,191	5,643,182,863	28,574,585	49,757,000

↑ 15 yrs ↓

39.67%

* Does not include all casinghead gas flared prior to August, 1952. Prior to that time casinghead gas not utilized was not required to be reported.

NOTE: GAS VOLUMES IN THOUSANDS OF CUBIC FEET (MCF) AT 14.65 PSIA and 60° F.

NINE DAYS ON THE BRINK

by

James E. (Jim) Nugent

Texas Railroad Commission

NINE DAYS ON THE BRINK

by

James E. (Jim) Nugent

The severe cold spell we experienced during December, 1983, had a profound effect on the Texas natural gas picture -- one which, I believe, bears our attention and study.

Specifically, I'd like to share with you information concerning nine days in December-- December 20th through the 28th.

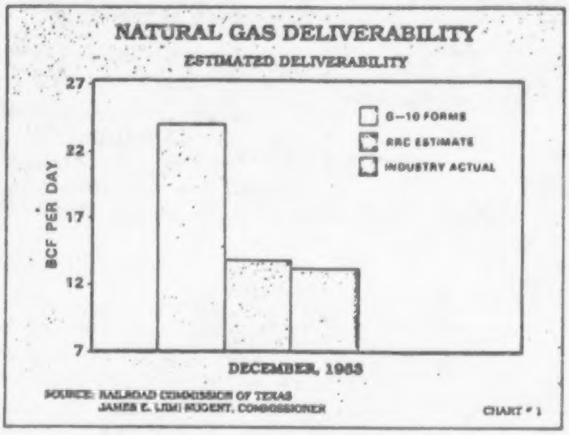
Nine prophetic days.

By looking closely at what happened during those nine days, I believe we can come to a fuller understanding of just what a serious problem we face in Texas natural gas supplies, and just as importantly, deliverability.

First, let's look at what we thought we could produce compared to what we were actually able to do.

NATURAL GAS DELIVERABILITY

ESTIMATED DELIVERABILITY



SOURCE: RAILROAD COMMISSION OF TEXAS
JAMES E. (JIM) NUGENT, COMMISSIONER

CHART #1

An average of just under 4 Bcf (billion cubic feet) per day of casinghead gas[1] is of course produced in Texas and makes up an approximate 4 Bcf "foundation," if you will. In looking at this chart (Chart #1) and all which follow, we'll refer to gas well gas, and the figures we will study today are on top of that foundation.

G-10 forms[2] filed with the Railroad Commission purport to show normal production potential for each gas well in the state. Altogether, our G-10 statewide totals show that in the month of December, 1983, the Texas producers should have been able to deliver in excess of 24 Bcf per day.

If that were anywhere near the truth, we would have had no problems in December, and we certainly would be sitting on a huge gas bubble.

Most knowledgeable people in Texas have not believed the G-10 reports for some time. However, some in Washington *have* chosen to believe them, and it's given rise to suggestions that we have additional capacity and are holding back.

But what those nine days in December show us is that, even with periods of over supply, the situation is more precarious than even we might have believed.

In studies conducted by my office, we determined that G-10 reports were significantly overstated. Our estimates (the second bar of Chart #1), on the other hand, showed December deliverability potentially at about 14 Bcf per day, or only about 60 percent of the G-10 reported volumes.

Later studies of actual December production (third bar, Chart #1) and deliverability throughout the nine days in December showed that we were about right--except for one important consideration: freeze-ups of both producing wells and pipelines' facilities.

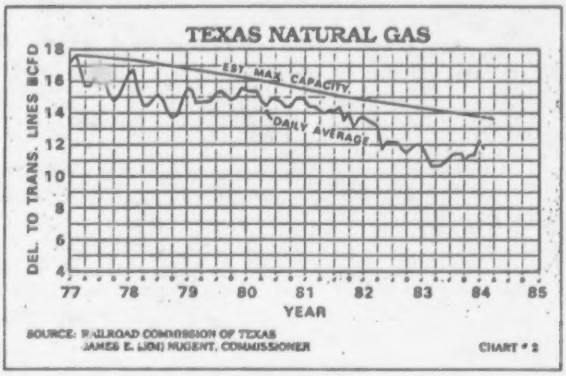
[1] Casinghead gas is that gas produced in conjunction with crude oil production. It has first priority in pipeline takes.

[2] G-10 forms report results of both initial well completion and periodic gas well deliverability tests.

These freeze-ups caused a reduction in deliverability of approximately .75 Bcf per day, reducing actual wide-open production to 13.5 Bcf--well below statewide demand during that cold snap.

So how *did* we meet demand? How were we able to supply the average of 16.7 Bcf per day which proved to be our absolute minimum demand without cutting off residential, human needs or Mom and Pop business operations?

I'll explain in a moment how we were able to accomplish the impossible.



SOURCE: RAILROAD COMMISSION OF TEXAS
JAMES E. (JIM) NUGENT, COMMISSIONER

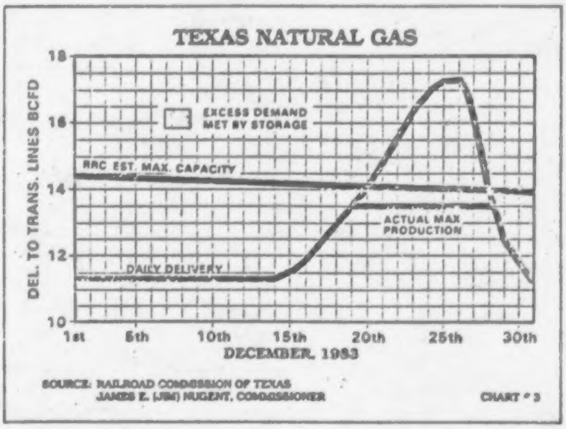
CHART # 2

For some time now, it has been apparent we have been experiencing an alarming decline in maximum production capabilities in Texas.

As opposed to the G-10 reports, the straight line at the top of Chart #2 shows that we at the Railroad Commission have *thought* Texas could produce, with all wells wide open, at maximum production.

The jagged line below shows gas actually delivered to pipelines in each month since 1977. The sharp drops in May of 1982 and again in March of 1983 reflect decreased demand which caused a reduction in production and the appearance of a gas surplus.

But look at what happened in December.



SOURCE: RAILROAD COMMISSION OF TEXAS
JAMES E. (JIM) NUGENT, COMMISSIONER

CHART # 3

For nine days in December, Texas experienced one of the coldest and most prolonged winter spells in recent history.

For nine days in December, not only did these two lines meet, but daily average deliverability to transmission lines actually exceeded maximum production capacity.

I point out to you that, bad as the situation was, it could have been much worse, had not the cold spell coincided with the holiday season.

- During the worst of those nine days, schools were closed.
- Many factories and businesses were closed for the holidays.

I might also add that the industry was aware well in advance that a severe cold spell was approaching Texas, and had made every preparation possible, including maximum line packs[3]. With the onset of the cold spell, most industrial users with the capability switched to fuel oil.

Let me give you a few selected examples of what we experienced during that period of time. While these few specifics are cited, they are representative of an entire scenario which was taking place throughout the state.

- As early as the 12th, the Panhandle began to feel the grip of cold. By the 18th, Amarillo had a low of zero degrees and a high of only 9 degrees.
- By the 19th, the Dallas/Fort Worth Metroplex had lows of 9 degrees and highs in the lower 20's.
- Central Texas temperatures ranged from the lower 20's to the lower 30's by the 20th.
- On Christmas day, the whole state was freezing solid.
- On the 20th, we began to have demand in excess of production. Lone Star Gas Company began curtailing industrial and special electric generation. Valero (a major Texas natural gas pipeline company) began drawing down from storage at rates of 700 MMcf (million cubic feet) per day. Line packs were falling everywhere.
- On the 23rd, North Texas was experiencing severe curtailments (cut-off of natural gas)--100 percent through all industrial categories--and would have had to curtail the next category, schools, had they been open.
- By Christmas day, only human needs were receiving gas. Valero was withdrawing from storage at maximum rates, but the storage pressure drop from earlier withdrawals reduced this take to only 560 MMcf per day.
- By Monday morning, the 26th, Lone Star's Line X (one of the company's two major gas pipelines in Texas) pressure had dropped from the desired 700 psi (pounds per square inch) to 400 psi--within 5 psi of operational incapacity. Valero had drawn down to within less than 2 Bcf of their usable storage capacity, and were still pulling down at reduced maximum rates of 500 MMcf per day.
- By Monday evening, the situation began to improve. Statewide appeals for voluntary conservation measures seemed to have taken hold, and the cold weather was easing.
- By evening of the 28th, the crisis was defusing. Valero began injecting into their storage reservoir. Lone Star line pressures were slowly climbing. By the next day, curtailments began to be lifted.

We had survived nine days in December--on the brink of disaster.

Our best information shows that an average of approximately 3 Bcf per day in excess of production capabilities was delivered to transmission lines. Or, to put it another way, with every well in the state producing at maximum capacity, we experienced a shortfall of more than 3 Bcf per day.

We were able to meet demand--and only barely--by drawing down from Texas gas storage reservoirs.

A total of about 30 Bcf was extracted from the state's ten storage reservoirs during the cold spell in December. Peak deliverability from these storage facilities was 3.435 Bcf per day.

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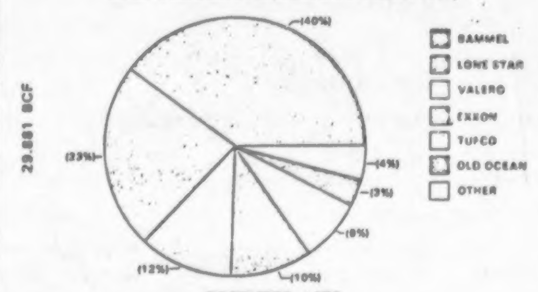
[3] Linepacking: Deliberate increase of pipeline gas pressure to force additional amounts of natural gas into existing pipelines. Another form of storage of gas supplies.

As you can see by Chart #4, we are all well-served by the investments companies have made in establishing gas storage reservoirs in Texas.

GAS RESERVOIR DRAWDOWN



DECEMBER, 1983

SOURCE: RAILROAD COMMISSION OF TEXAS
JAMES E. (JIM) NUGENT, COMMISSIONER

CHART #4

Houston Pipeline Company's Bammel reservoir supplied a total of 11.8 Bcf during the cold spell, including some additional drawdowns after December 28th.

Bammel has a total capacity of 110 Bcf, making it probably the finest storage reservoir in the country.

More important than Bammel's significant capacity is its ability to deliver--up to a full BILLION CUBIC FEET per day.

- Bammel was thus able to supply fully 40 percent of the total drawdown required to meet excess demand during the duration of the cold spell;
- Lone Star, which has several smaller storage systems in the state, was able to contribute 25 percent to our desperate needs;
- the other major storage facility in Texas, owned by Valero Transmission Company, supplied 12 percent;
- Exxon's multiple reservoirs supplied 10 percent;
- TUFCO's two storage reservoirs eight percent;
- Old Ocean, a retrograde cycling field, three percent; and,
- four other smaller facilities made up the rest.

At that, it was barely enough.

For nine days in December, the natural gas industry in Texas found ways to accomplish the impossible.

Of course, demand exceeding deliverability is not typically the case. We must find a balance between lower year-long market demand and ability to supply during peak demand periods.

We must let the marketplace establish a level of profitability which will insure sufficient exploration to avoid shortages and curtailments such as we experienced during nine days in December.

Finally let me remind you that three years ago, the Railroad Commission restrained regulatory authority in favor of an industry advisory committee empowered to secure the best voluntary compliance of natural gas allocation by the best experts in the business--those that handle the gas.

Our restraint and use of this voluntary allocation committee and the results obtained demonstrated what can be accomplished when the problem is shared by all those involved. The expertise and knowledge they put to work--during nine days in December on the brink of disaster--worked for the benefit of all Texans. They are to be congratulated.

"FOREVER BLOWING BUBBLES"

or

We must learn the Truth and Speak it Convincingly

W. J. Murray, Jr.
Austin, Texas
June 11, 1984

My purpose today is threefold: First, to use a catchy title to bring to your attention a matter of serious national concern. Second, to suggest to representatives of state regulatory bodies present a realistic method for determining natural gas producing capacity and then to urge them to speak out convincingly as to the true nature of the gas bubble. Third, to summarize the recommendations of the Texas Ratable Take Committee and report on steps being taken to implement these recommendations.

The title, with poetic license, comes from the lyrics of an old song:

> "We are forever blowing bubbles,
> Pretty bubbles in the air,
> They fly up so high,
> They nearly reach the sky,
> But then they fade away and die.
> We are forever blowing bubbles in the air."

Obviously we are referring to the overstated gas bubble which has caused the nation to return to complacency relative to future gas supply. The temptation is great to describe the oil and gas bubbles of the last 50 years and recount how the nation has refused to heed warnings until shortages developed and then panicked and refused to believe that the ingenious, competitive, American oil and gas industry with adequate incentive and minimum regulation could solve these shortages.. But time does not permit such a history lesson and I am unwilling to acknowledge that I have been observing these cycles for as long as 50 years.. So we will pass up history except for the warning "He who will not learn from history is destined to relive it".

Instead, we will begin with conditions today - June 1984 - and look forward.. Many of you with greater eloquence and greater credibility have been issuing the same warnings as this speaker, but perhaps not for as long as 50 years, of overstated gas bubbles. Members of the Texas Railroad Commission have been particularly diligent in these warnings and I would like to quote from statements made this year. February 17 News Release: "Railroad Commission Chairman Mack Wallace said that the nation's widely-reported natural gas 'bubble' disappeared in Texas during the Christmas cold snap and that the state's gas suppliers 'narrowly averted human suffering from lack of heat and electricity'. The currently available supply of gas in Texas - and quite probably in the nation - appears to be grossly overstated. Texas and the nation face a potential energy crisis, a serious one, over natural gas supplies in the not too distant future." Railroad Commissioner Jim Nugent has prepared a pamphlet with dramatic colored charts describing how Texas "survived nine days in December on the brink of disaster". Commissioner Nugent states that G-10 gas delivery tests indicated that Texas should have been able to deliver in excess of 24 BCFD, but when the gas was desperately needed, we found a delivery capacity of only 14 BCFD or about 60% of the reported capacity. "Most knowledgable people in Texas have not believed the G-10 reports for some time.. However, some in Washington have chosen to believe them....but.....the situation is more precarious than even we might have believed".

But did the precarious situation in January when many states, certainly Texas, Louisiana and Oklahoma were "on the brink of disaster" awaken the nation and burst the gas bubble? If so, not for long. The proposed Sharp gas recontrol bill before Congress finds that "most natural gas is currently priced at above market levels and a surplus of deliverable natural gas presently exists." The Mar. 1984 Atlantic Monthly has an article entitled

"America's Plentiful Energy Resource" from which we quote: "Today the nation is experiencing a glut of gas so severe that producers are capping wells by the thousands. Respected authorities estimate that we have a 75 year reserve while visionaries speak in terms of hundreds of years ." In the April 1, 1984 Gas Watch, Cyrus Lawrence gives four reasons for disagreeing with Chairman Mack Wallace's statement earlier quoted herein and suggests that the true Texas deliverability is about 5 billion or 1/3rd more than the Railroad Commission's estimate. These quoted statements seem typical of congressional, media, consumer and even industry attitudes. Majority Leader Jim Wright has stated that "At least Old Rip didn't go back to sleep." But we would have to conclude that most of the nation has. "We are forever blowing bubbles, pretty bubbles in the air."

My second purpose is to describe methods to be used in determining true available gas supply. Since we have already used one song lyric, we might quote another - "Don't tell me, show me". My recommendation is very simple - do not rely on calculated open flow poetntial or individual well delivery reports, but ascertain how much gas in total is actually delivered during the occasional periods when demand exceeds supply. I would like to call your attention to Chart #1. The lower line is the actual monthly reported delivery to transmission lines but calculated on a daily average basis. The shaded pinnacles above the upper line represent the time periods and the estimated quantity when curtailed demand exceeded supply. On each such occasion when we could not fully meet demand and were desperately working to meet essential human need it was possible to realistically determine the true, as contrasted with the reported or theoretical, available supply. If you examine the chart closely, you will note that I have placed thereon a point representing my estimate of the ture daily capacity during these periods of peak demand. The upper line on Chart #1 is obtained by connecting these points representing periodic total capacity determinations. To my surprise and disappointment it is very nearly a straight line and has been continuously declining since 1977 in spite of periods of alltime record gas well completions.

Your attention is now directed to Chart #2 which is a plot of annual well production by year of completion. These data were retrieved by the Texas Railroad Commission from their computer. The upper solid line is the total annual production from all Texas gas wells.. The dash line labeled "estimated total capacity" is one about which there can be valid skepticism. It is obtained by reading the midyear daily capacity from Chart #1 and multiplying by 365. It is readily acknowledged that it would not likely be possible to produce all of the wells in Texas for 365 days at the maximum rate obtainable during the periods of peak demand "when we were on the brink". I would have difficulty disputing an argument that this overstates the surplus, but most of the skeptics contend instead that the surplus is much, much larger.

Before describing the bar graph on the right of Chart #2, I would ask you to refer to Chart #3. On this chart the annual vintage production from 1977 thru 1983 is inflated to the estimated quantity had the wells produced wide open through the entire year. These inflated points plotted on semilog graphs produce relatively straight lines and reasonably parallel lines for each 5 year vintage increment. To the mathematical experts this adds some measure of credibility for future projections and the conclusion is, as shown on the bar graph, that if in 1986 the demand for gas is no greater than it was in 1982 then only 1/2 of this demand can be supplied if all of the wells producing gas in 1982 were produced at capacity throughout 1986. Please recall that in 1982 we had a severe economic recession, a cool, wet summer, and we cancelled winter. For some gas systems, it was the warmest in 35 years, for other companies, in 50 years. Surely it is not unreasonable to anticipate that we will need at least as much gas in 1986.. But will we drill enough wells to supply the other 1/2 of the 1986 demand? Not at current rates. Should Congress act to encourage development rather than to discourage it? That is not for me or perhaps you to say. My plea is only that "we learn the truth (about deliverability) and speak it convincingly."

The third objective of these remarks and the original purpose of your invitation is to update the Ratable Take Committee report and describe steps taken to implement the recommendations contained therein. The title of my presentation before the Legal Committee of this Compact one year ago was Ratable Take of Natural Gas - Difficult to Achieve But of Proven Public Benefit. You will recall the minister who described his sermons as follows: "I tell my congregation what I am going to tell them, then I tell them, and then I conclude by telling them what I have already told them." I will not repeat the Legal Committee speech, but strongly reaffirm the statements made therein and in particular the title. As anticipated in that speech, the rather voluminous Ratable Take Committee report (now available from the Texas Railroad Commission) which was delivered to the Railroad Commission one month later strongly recommended ratable take of natural gas as being very much in the public interest, of benefit to producers, pipelines, and in particular to consumers. The report also warned that natural gas delivery capacities were considerably overstated and declining and that the "bubble" would probably disappear by 1985 or 1986.. In addition to the other public benefits described in the report, it was emphasized that ratable take regulations would encourage increased exploration and development for desperately needed new reserves by assuring such new wells a share of the currently depressed market.

But the committee acknowledged, as I had also anticipated in my IOCC speech, that ratable take would be difficult to achieve. A number of problems were discussed in the report of which we will consider three and the steps which have been taken to solve them. First, the committee pointed out that nominations for gas by purchasers have long been substantially excessive. Much was accomplished in solving this problem simply by having representatives from substantially all of the natural gas pipelines serve as members of the Technical Subcommittee of the Ratable Take Committee. The general excuse for over-nominating was that the economy might suddenly improve or the weather turn cold or hot and no pipeline wanted to be caught short of gas supply. Moreover, some pipelines seemed to feel they might have a better defense against take-or-pay claims if they nominated high, but hopefully the Railroad Commission would not believe them and would set the allowable much lower.

It was pointed out to the pipelines that safety factors are built into the ratable take system which permit gas wells, if unanticipated demand occurs, to produce at double their assigned allowable without bothering to obtain permission, and at four times the allowable by a simple request. It was also intimated that the CEOs of those companies might be "invited" to a statewide hearing and asked why they invariably nominated spring or fall, winter or summer for almost twice as much gas as they actually needed. Whatever the cause, nominations from most of the gas companies are now on an average exceedingly accurate.

The second problem dealt with the overstated delivery reports submitted on Form G-10. The Railroad Commissioners, the Commission staff, and the Ratable Take Committee all reported in 1983 that although the G-10s totalled 24 BCFD., the estimated true capacity was only approximately 14 BCFD. The Ratable Take Committee recommended that the gas purchaser (pipeline) be required to approve the producer's periodic G-10 tests in the future. This recommendation has been implemented by the Railroad Commission and I believe that the accuracy of G-10's will be improved as a result therof. But with embarrassment I forecast that G-10's will always overstate true deliverability perhaps by one-third rather than two-thirds as in the past.

But should ratable take regulations be abandoned because it may never be possible to obtain truly accurate individual well delivery tests? Absolutely not! Since in most gas fields each individual well's share of the allowable is calculated on acreage or some factor other than deliverability, erroneous G-10 reports do not materially change a producer's share of the allowable in a common reservoir.

Perhaps in the future, but with regretted consumer hardship, demand may exceed supply for more than a calendar month and the state regulatory bodies who have ratable take regulations based on delivery can then order that each well's delivery capacity for allocation purposes will be the average quantity produced and delivered during the most recent month when demand exceeded supply.

A third problem considered by the Committee was whether gas should be prorated, like oil, pn a statewide "across-the-board" basis or whether ratable take should be required for each separate pipeline system. This was and still is the subject of considerable legal, economic, and equity argument. But a majority of the Committee concluded that ratable take regulation by pipeline system should be improved and implemented before attempting a much more difficult "across-the-board" statewide plan. Your speaker concurs although he is proud of a role in developing the statewide "across-the-board" oil proration plan. But I remember that it took fifteen years to perfect oil proration by area and system before we were ready for statewide proration. Unless we arrest the decline in the gas deliverability curve, we will have no surplus to prorate long before we are ready for statewide proration.

With this statement I conclude. If we are to continue "Forever

Blowing Bubbles", somebody like the IOCC with knowledge, guts, and credibility should burst a few before they reach the sky. Do not let producers tell you what their wells can produce - make them show you. Do not let the nation count on domestic gas, as it did on oil a decade ago, which will not be available to meet a future emergency whether occasioned by weather or an international political or military crisis. Finally, remember that ratable take of oil prevented physical waste, protected correlative rights, and encouraged development of new reserves during a decade when we had an overstated oil glut. Let's make it do the same thing for gas.

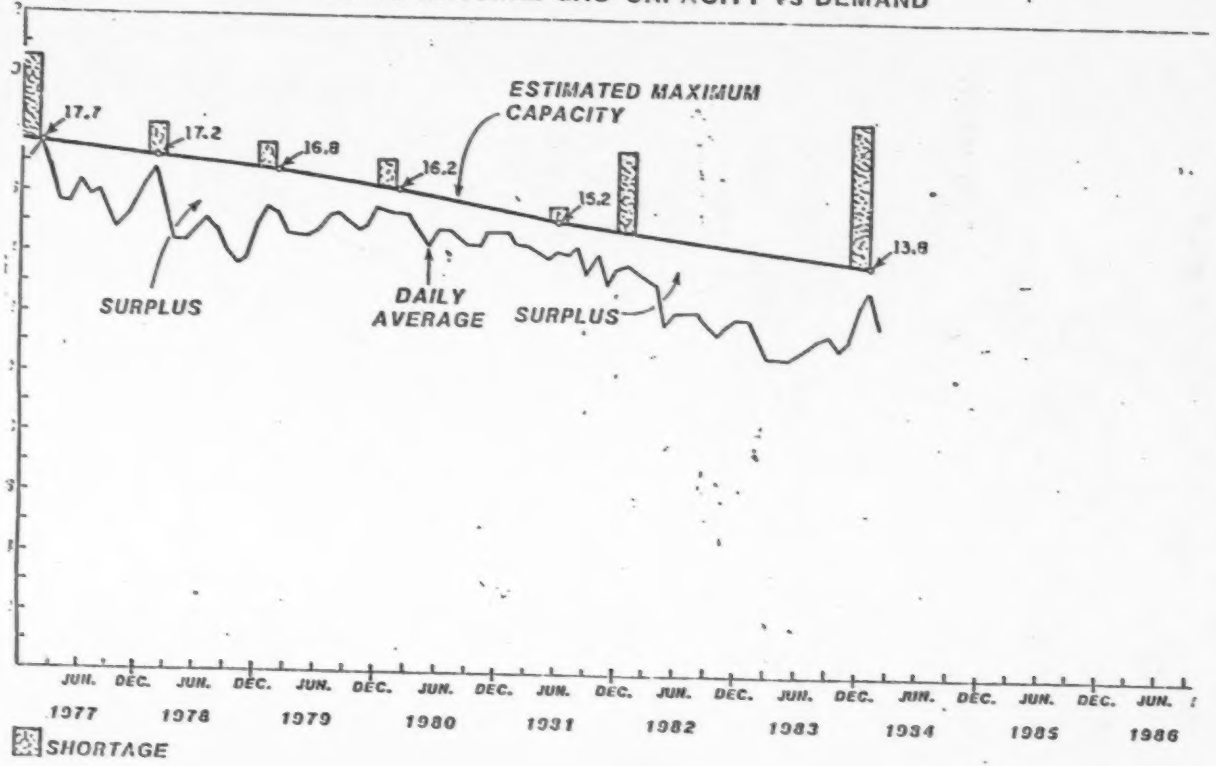
Yesterday's (June 10) San Diego Union contained an editorial from which I quote:

> "We think the House bill (sponsored by Rep. Philip Sharp) is bad legislation, a retreat back toward price regulation that can only compound the problems of the gas industry while providing no benefit to consumers in the long run...Extending price controls... would only discourage exploration and development and lead to shortages a few years hence. The government does consumers no favor when it mandates a low price for natural gas - and creates conditions assuring that there will not be enough gas to go around on some cold winter day in the future."

Perhaps IOCC should not become involved in natural gas pricing, but it should develop accurate supply data which might help avoid disaster on "some cold winter day in the future."

CHART #1

TEXAS NATURAL GAS-CAPACITY vs DEMAND



BY YEAR OF COMPLETION

CHART #2

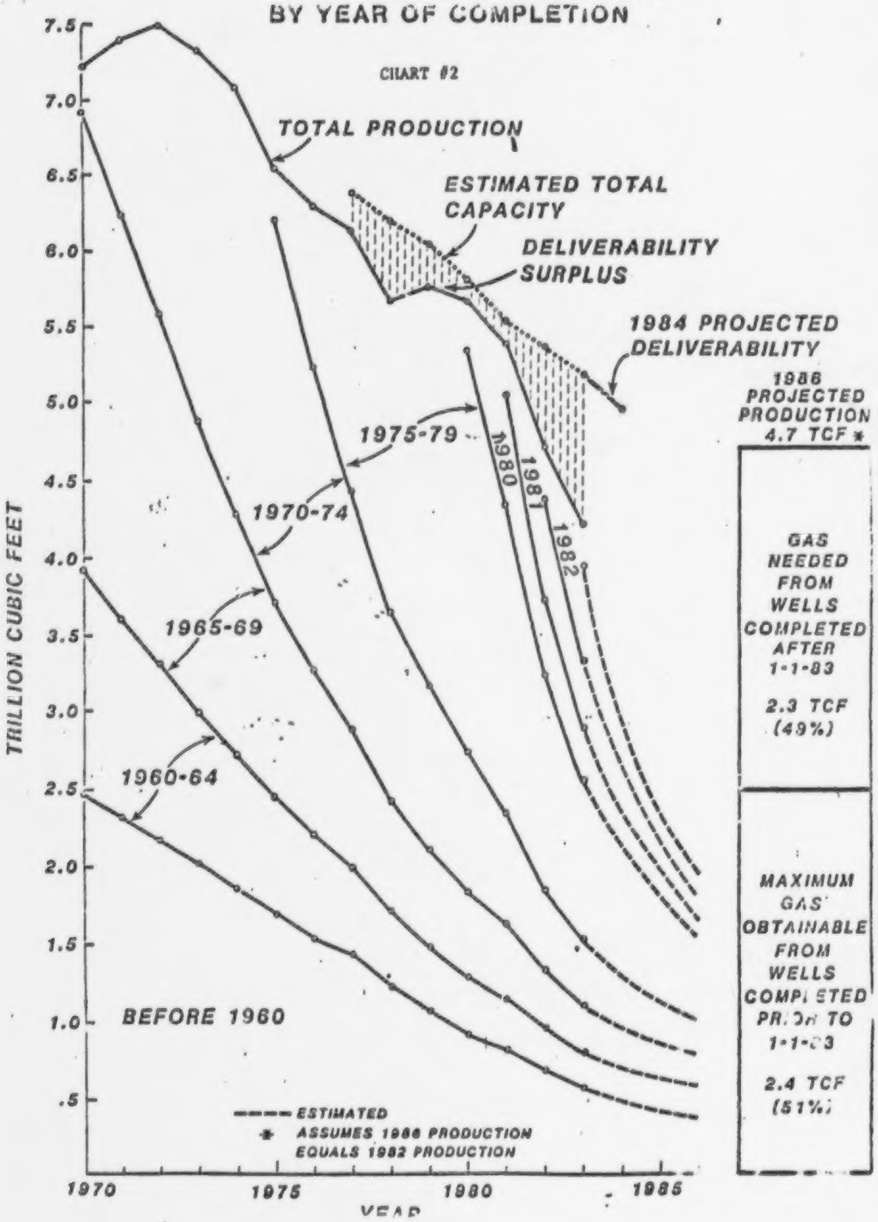
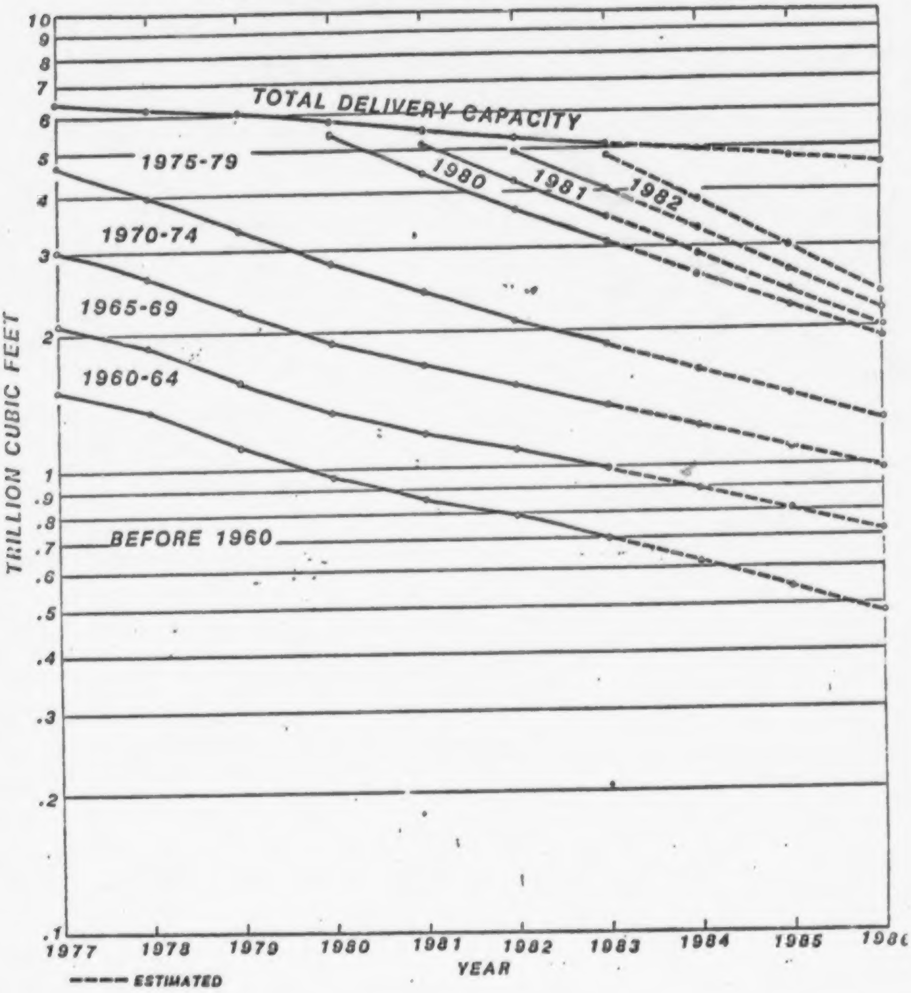


CHART #3

TEXAS GAS WELL CAPACITY BY YEAR OF COMPLETION



[From the Houston Chronicle, Feb. 7, 1985]

GET OFF THE SUICIDE COURSE ON ENERGY

(By Mack Wallace)

The unbridled, growing level of imported oil into this country is playing havoc with America's energy security.

In addition, our energy position is made substantially worse by our own federal government's internal struggles over the proper role energy and the producers of energy are to play. They can't seem to make up their minds whether oil and gas produced on home soil is good or bad—and whether the finders of oil and gas should be punished or encouraged.

It is a tragedy that America's long-term energy future is so dependent on policymakers with such short-term visions.

While unconstrained imports from unstable sources inch upward, one branch of our own government proposes to effectively cut domestic oil and gas discovery incentives which would further reduce our own ability to explore for energy resources.

The combination of the two issues—rising imports and domestic exploration—is a suicidal course for this country to follow.

I believe some extraordinary actions must be taken to reverse this trend.

First, a tax should be levied on imported oil.

Second, incentives for domestic exploration and production should be expanded, not curtailed. If we ever lose the ability to produce the energy needed for ourselves, then we will have placed our country in jeopardy.

In 1951, one of my predecessors on the Railroad Commission, Ernest O. Thompson, told a congressional committee:

"It is not too much to say that petroleum protects freedom. Our cars, trucks, tanks, ships and airplanes all require petroleum in great quantities. * * * One day without oil would paralyze our economy. . . .

"We cannot afford to let anything happen that would lessen the incentive to hunt for oil in the United States. * * * This nation can ill afford to increase its dependence upon foreign sources of petroleum. * * *"

That statement is no less true today than it was 34 years ago.

Unless the leadership of this nation brings the issue of "energy security" to the forefront and affords the issue its proper position high on the agenda of national and international affairs, it is my belief that an economic and strategic crisis will face this country in the not too distant future.

Twelve years ago, our nation was almost brought to its knees by an Arab oil embargo that caused shortages, set off an inflationary spiral and forever changed the world's view toward energy. Energy matters suddenly jumped to the front pages.

With few exceptions, the Congress and four presidents during this period have been content with providing short-sighted, often complex and contradictory answers to questions that demand our very best long-term planning.

Time and time again, solutions that would strive for energy security—both economic and strategic—elude our nation's leaders. Our solutions have failed to match the problems and challenges ahead.

Instead, complacency once again has replaced responsibility.

Defenders of the status quo point to successful conservation efforts and lower prices.

It is certainly true that the powerful OPEC cartel has been shaken, that gasoline prices are falling, and that the nation's Strategic Petroleum Reserve now contains more than 400 million barrels of oil.

But this is not enough energy security for America when these facts are considered:

Our imports of crude oil and crude oil products, at almost 6 million barrels per day, are increasing and today account for more than 30 percent of our needs.

In 1984, energy imports accounted for 45.3 percent of the nation's entire trade deficit. In 1983, our energy deficit—as a percentage of the country's total trade deficit—amounted to 85.6 percent.

Since 1973, the cost of crude oil and crude oil product imports into the United States has totaled more than $500 billion. That ought to be unacceptable to the Congress and the American people. It is to me.

We are using natural gas faster than we are finding it, despite a temporary—and I emphasize "temporary"—oversupply.

Wallace is the senior member of the Texas Railroad Commission.

Serious unanswered questions about distributing the crude oil in the Strategic Petroleum Reserve in a potential crisis have yet to be satisfactorily addressed. For one thing, the system has not been fully tested. Furthermore, that 400 million-plus barrels is a scant amount to have to rely upon when viewing our country's overall energy requirements that may arise in an emergency.

OPEC's bickering and apparent inability to maintain control over world oil prices and supplies should not be so readily dismissed. OPEC's apparent momentary loss of influence could earily be retrieved in the future considering the historic volatility of the Middle East. Many countries, including our allies, are still heavily dependent on OPEC for their supplies.

While conservation has played a key role in America's energy picture, fuel consumed by major transportation sectors of the country is on the increase. In 1983, automobiles used 70.4 billion gallons of gasoline—in 1984, 71.5 billion gallons. In 1983, trucks used 44.6 billion gallons of fuel—in 1984, 46 billion gallons. In 1983, airlines used 16.56 billion gallons of fuel—in 1984, 18.09 billion gallons.

Against this backdrop of warnings, what are some of the solutions being offered?

One plan by Stewart L. Udall, former Interior secretary, is to reduce our trade deficit by taxing gasoline at $1 per gallon at the pump. Such a plan, he said, would also "enable us to share some of our remaining oil with our children * * *."

That plan, I say, would go a long way toward breaking the back of every working man and woman in the country who must drive to his or her job, and it does absolutely nothing about the search for oil and gas.

Another more pervasive and dangerous proposition is being put forth by the Treasury Department. Under the name of "tax reform," this proposal would effectively dry up domestic exploration by eliminating the percentage depletion allowance and intangible drilling costs. These two issues are not benefits designed to enrich oil and gas producers, but represent governmental recognition of the risks and the capital needed in the long process of finding, developing and producing energy.

Those tax incentives are also a recognition by the government of the strategic necessity of these fuels.

Energy is the lifeblood of this nation and both the short- and long-term solution for energy security in America is increased, sustained domestic production, free from federal pricing schemes and bureaucratic regulations that thwart the search for and development of our energy resources.

And, because of our growing imports, and huge energy trade deficit, I would propose an import tax on foreign crude oil and crude oil products with the goal of "improving the terms of our trade." Oil and crude oil products are all that OPEC has to export. If the Western world doesn't buy it, who will?

So, in conjunction with expanded incentives for domestic exploration, we make the terms for imports a little tougher.

The idea is not a new one. The belief that tariffs will shift the terms of trade somewhat against the foreigner goes back 150 years, to John Stuart Mill.

A judicious small tariff—not a prohibitive one—might improve a country's terms of trade, it is thought. A $2-per-barrel import fee on crude oil and products imported into this country would bring in $17 billion during the next five years. A $5-per-barrel fee would bring in $42.5 billion over the same period.

In my view, if steel and automobiles are considered strategic imports into America and high-level negotiations are appropriate in discussions of their impact on American industry and trade, then energy certainly is no less a strategic issue. Neither the manufacture of steel nor the movement of automobiles can be accomplished without oil.

The time is now to set this country back on a sane energy course.

If we are ever to have domestic energy security in America, this dependency and ho-hum complacency must be replaced with a determination to achieve independence.

I believe we need to bring our drilling rigs home and boost American production by drilling 25,000 more wells per year. We have never fully inventoried our own federal lands and the outer continental shelf for natural resources.

We have the equipment and technology that is the envy of the world and we have the people to accomplish it.

Let's stop "eating our seed corn" and start a domestic exploration program in earnest as a matter of national interest.

In 1949 the National Petroleum Council declared: "The nation's economic welfare and security require a policy on petroleum imports which will encourage exploration and development efforts in the domestic industry and which will make available a maximum supply of domestic oil to meet the needs of this nation."

Isn't it time we do that?

Senator NICKLES. Mr. Stansberry, thank you very much.

Our next panelist is Mr. Huston Huffman, senior vice president, First National Bank of Oklahoma City.

Mr. Huffman.

STATEMENT OF HUSTON HUFFMAN, JR., SENIOR VICE PRESIDENT OF LENDING, FIRST NATIONAL BANK & TRUST CO., OKLAHOMA CITY, OK

Mr. HUFFMAN. Thank you, Mr. Chairman.

On behalf of the Oklahoma banking community, we appreciate the opportunity to share with the Senate committee our concerns about the energy tax provisions of the Treasury's tax simplification proposals and their potential ramifications on the oil and gas industry and the economy.

Overall, we believe the proposed changes in the tax treatment of intangible drilling costs and percentage depletion will significantly reduce the amount of capital available for oil and gas exploration and development, discourage domestic drilling activity, lead to greater dependence on foreign energy supplies, and place the American consumer at the mercy of the whims of OPEC and the inherent uncertainties of the foreign crude.

As those of us familiar with the oil and gas industry are aware, it is a very capital-intensive business.

Furthermore, the money invested in oil and gas exploration and development is true venture capital with very high risks.

Federal tax policy has recognized this fact over the years and has provided certain incentives to encourage domestic production. We also understand the theoretical free market approach advocated by the Treasury Department.

In theory, and assuming a free market and an independent economy, the price of oil and gas should adjust upward to a point where investors would be economically motivated rather than tax motivated. As stated in the Treasury's report, this is the underlying rationale of the proposal.

However, as we are all aware, the energy industry does not operate in a Utopian free market environment. Both the supply side and the demand side of the energy market equation are very distorted. We are dealing with the OPEC cartel, for example, and the Fuel Use Act, on the other side of the equation.

Consequently, given the dominant effect foreign supplies have on our domestic market, increased prices would not occur until worldwide shortages were experienced.

Therefore, given the reality of the marketplace, the initial result would be greater reliance on imports, potential shortages in the event of interruptions in foreign supplies, and an adverse effect on domestic producers.

By its own admission, the Treasury report agrees with this scenario and states that these effects might be burdensome in the short run.

Thus, it seems that the justification for the proposed changes is Treasury's optimistic philosophical view of the long run.

Unfortunately, those of us in areas closely associated with and dependent upon the economic health of the domestic energy industry's struggle to survive in the real world simply cannot rest upon the promises and hope over the long haul.

The question then becomes: How many energy businesses will we lose in the short run, how many people will lose their jobs, and what will be the price of all this to the American consumer?

Of course, the State of Oklahoma will carry a big load of those burdens, just because it is a major source of oil and gas production in the United States. We can't ignore the fact that the oil and gas industry is one of the pillars of our economy.

By the same token, we take pride in the fact that we contribute to the overall domestic production in order to help our country become more energy self-sufficient.

The proposed tax changes will have an immediate impact on employers providing products and services to the exploration and development segments of the industry, specifically drilling contractors and suppliers of goods and services associated with the drilling and completion of oil and gas wells.

Eventually, companies supplying goods and services for the operation of wells would be hit as the number of producing wells can be expected to diminish dramatically when drilling activity subsides.

The entire industry can be expected to shrink dramatically over a relatively short time, impacting all those industries which support a vibrant and expanding economic base, such as housing, manufacturing, retailing and, of course, banking.

Also, with a declining tax base, state and local governments will no longer be able to provide the level of services necessary to attract and diversify the economy.

In summary, taking away the capital available to the oil and gas industry will be far-reaching. While it is impossible to determine the vast consequences that the domino effect would have on oil and gas producing sectors, the Interstate Compact Commission has done an extensive analysis of the potential impact of the proposed energy tax provisions.

To say the least, it paints a bleak economic picture and quantifies some of those shortrun burdens alluded to by the Treasury Department.

And last, all of us, producers and consumers alike, should be troubled by those policies which would abandon our domestic efforts to become less reliant on foreign energy.

A healthy domestic energy industry is vital to our economy and national security. We strongly encourage you and members of the Senate Energy Committee to carefully consider and weigh the economic and social consequences of those proposals, instead of blindly embracing their theoretical long-term application.

Thank you, Senator.

[The prepared statement of Mr. Huffman follows:]

TESTIMONY BY HUSTON HUFFMAN, JR.
SENIOR VICE PRESIDENT OF LENDING
FIRST NATIONAL BANK AND TRUST COMPANY OF OKLAHOMA CITY

Mr. Chairman and Members of the Committee:

My name is Huston Huffman, Jr., and I am Senior Vice President of Lending for The First National Bank and Trust Company of Oklahoma City. On behalf of the Oklahoma banking community, we appreciate having the opportunity to share with the Senate Committee our concerns about the energy tax provisions of the Treasury Tax Simplification proposal and their potential impact on the oil and gas industry and the economy.

Overall, we believe the proposed changes in the tax treatment of intangible drilling costs and percentage depletion will significantly reduce the amount of capital available for oil and gas exploration and development, discourage domestic drilling activity, lead to greater dependence on foreign energy supplies, and place the American consumer at the mercy of the whims of OPEC and less stable foreign markets.

As those of us familiar with the oil and gas industry are aware, it is a very capital-intensive business. Furthermore, the money invested in oil and gas exploration and development is true venture capital with very high risks. Federal tax policy has recognized this fact over the years and has provided certain incentives to encourage domestic production. We also understand the classical economic, free market approach advocated by the Treasury Department. In theory, and assuming a free market and independent economy, the price of oil and gas should adjust upward to a point where investors would be economically motivated rather than tax motivated. As stated in the Treasury's Report to the President this is the underlying rationale of the proposal.

However, as we are all aware, the energy industry does not operate in a Utopian free market environment. Both the supply side and the demand side of the energy market equation are very distorted, i.e. the OPEC cartel, Fuel Use Act, etc. Consequently, given the dominant effect foreign supplies have on our domestic market, increased prices would not occur until worldwide shortages were experienced. Therefore, given the reality of the marketplace, the initial result would be increased reliance on imports, potential shortages in the event of interruptions in foreign supplies and additional financial strain on domestic producers.

By its own admission, the Treasury Report agrees with this scenario and points out that these ramifications might be burdensome in the short run. Thus, it seems that the justification for the proposed changes is Treasury's optimistic philosophical view of the long run. Unfortunately, those of us in areas closely associated with and dependent upon the economic health of the domestic energy industry struggle to survive in the real world and simply can't rest upon the promises and hopes over the long-haul. The question then becomes; how many energy businesses will we lose in the short run, how many people will lose their jobs and what will be the price of all of this to the American consumer?

Of course, the State of Oklahoma will carry a big load of those burdens simply because it is a major source of oil and gas production in the United States. We can't ignore the fact that the oil and gas industry is one of the pillars of our state's economy. By the same token, we take pride in the fact that we contribute to the overall domestic production in order to help our country become more energy self-sufficient.

The proposed tax changes will have an immediate impact on employers providing products and services to the exploration and development segments of the industry; specifically, drilling contractors and suppliers of goods and services associated with drilling and completion of oil and gas wells. Eventually, companies supplying goods and services for the operation of wells would be hit as the number of producing wells can be expected to diminish as drilling activity subsides.

The entire industry can be expected to shrink dramatically over a relatively short time frame impacting all those industries which support a vibrant and expanding economic base such as housing, manufacturing, retailing, and of course banking.

Also, with a declining tax base, state and local governments will no longer be able to provide the level of services necessary to attract new and diverse industries.

In summary, shifting away the capital available to the oil and gas industry will be far-reaching. While it is impossible to determine the vast consequences that the domino effect would have on oil and gas producing sectors, the Interstate Oil and Gas Compact Commission has done an extensive analysis of the potential impact of the proposed energy tax provisions. To say the least, it paints a bleak economic picture and quantifies some of those short-run burdens alluded to by the Treasury Department. And last, all of us, producers and consumers alike, should be troubled by those policies which would abandon our domestic efforts to become less reliant on foreign energy.

To paraphrase Newton's Third Law of Motion . . . for every action there is an opposite reaction . . . A healthy domestic energy industry is vital to our economy and national security. We strongly encourage the members of Congress to carefully consider and weigh the economic and social consequences and reactions of these proposals instead of blindly embracing their theoretical long-term application.

Senator **Nickles**. Thank you very much, Mr. Huffman.

I have a question for the bankers on the panel. Many times when I am traveling around, I try and get an idea of the health of the economy of an area or the health of a particular industry.

We have seen a lot of shakeout. Have we seen most of it, as far as the banks are concerned?

A lot of banks have had to write some pretty nasty losses in the last couple of years.

Mr. **Huffman**. The banking industry in this part of the world, as is well known, has certainly taken a beating over the past 2½ to 3½ years. We would like to think, naturally, that the end is in sight.

However, today we are dealing with a local economy that is experiencing some pretty severe drops in prices of the primary product, oil, natural gas, not seeing significant increases in volumes, continuing to see softening prices.

In the event the tax simplification proposal were to pass, I would not expect anything but continued deterioration in the local regional economy as well as in the banking industry.

Senator **Nickles**. Is there still some shakeout in process, even without the proposal?

Mr. **Huffman**. There will be shakeout for some time, I think. I believe the worst has probably passed.

Senator **Nickles**. What about for the oil industry itself?

Mr. **Stansberry**. Oh, yes, I think so. I think yesterday the Wall Street Journal summed it up pretty well. It said:

> Banks in large measure determine how far the industry will fall. They have been among the slump's worst victims, but many bankers are still inclined to hope that resurgence in the whole process will come about. Now banks are increasingly inclined to pull the plug.

That sums up not only the banking side, but——

Senator **Nickles**. Well, the oil and gas side is that as bankers, you sit on loan committees and you have companies come to you, and you know how much of an extra yard you are going to give them.

In many cases, are there still a lot of companies that you are really working with and your loan committees are saying, "Let us try and carry this person a little longer"?

Mr. **Huffman**. I think the banking community as a whole at the outset of 1984 had the attitude that there would probably be some improvement in our local economy, specifically oil and gas.

I am afraid, however, that as a result of that attitude, 1984 saw the industry probably willing to work with the problem debtors more so than might normally be the case.

However, today, I think the industry, looking forward into 1985 seeing some of the effects that we have seen just in the last 60 days, I think the banking community is taking a different approach, a much more pessimistic approach, and anticipating at least another 18, 36 months downturn in the economy.

They are approaching their borrowers accordingly, their troubled borrowers accordingly.

Senator **Nickles**. We had a series of bank failures in the State of Oklahoma last year.

Do you think 1985 will be at the same level, worse, or better?

Mr. HUFFMAN. I would certainly hope not, but I would not feel comfortable speculating.

Senator NICKLES. I am not either. I shouldn't have asked the question. I am nervous and afraid of what you might say.

Many times I ask the accountants, because they work with this complicated system that we have. It is a burdensome and complicated system, and that is one of the reasons why you see the public push for revision and simplification, reform, or whatever.

There may be some impression by some in Washington, DC, that independent oil and gas producers just do not pay any tax.

Is that a fallacy? Do you work with returns?

Mr. BRADEN. Well, I think in some situations there are people who, with the availability of currently expensing intangible drilling costs, it is possible there are years in which an independent producer who is real active and takes an awful lot of risk and spends an awful lot of money, in those particlar years they may not pay tax.

Although when you look at individuals with the alternative income tax, corporate income tax that are in place, it is very difficult to ever reduce tax liabilities to zero. And I do not think that that is necessarily an objective.

As you have well pointed out, there are an awful lot of other taxes that are imposed other than the income tax, and it is not—most of my clients do pay taxes and they are concerned about it, or else I would not be here working.

Mr. RILEY. Senator, if I might address that question, too.

Currently, my practice is entirely with oil and gas producers, developers, drillers, and related service companies. We are working with recently—two cases come to mind.

One was where we were trying to bring down that tax burden with year-end accruals and we saw we had no problem with reducing our taxable income when we accrued interest on our outstanding loans.

The banks have recognized the problem and difficulty of collection of some of the loans and they continue to work with good clients in the area.

The other situation, I do have a client who for the last 3 years will have paid no taxes because this year we are going to carry back some significant operating losses to offset those prior year taxes.

Those are not fictitious losses or phantom numbers. Those are real losses in terms of dollars spent in excess of revenues earned.

I think the independent producers in this State are quite large income taxpayers and have been as long as they were able to make a profit.

Senator NICKLES. A lot have gone out of business. I do not know how to quantify the number of independent producers that have gone out of business in the last 2½ years, but a lot have.

Those that did not go out of business and were not making money did not pay taxes, I would imagine, except for the windfall profit tax and maybe some additional excise taxes.

I am trying again to get some kind of an idea as to the health of the independent sector financially, and also, maybe, to expose the fallacy of this idea. I think there are some in Washington, DC, who have had the concept that those who are investing in the oil and gas area are strictly doing it for a tax deduction.

Mr. **Riley**. There is a real misconception among perhaps bureaucrats or other legislators from other parts of the country about what they call this average investor. They are trying to put all investments on equal terms so that they can be judged equitably and fairly among all of us.

Yet, as has been pointed out, when you take a risk investment, such as in oil and gas, that involves spending money. You have to write a check. Your return on that investment is only going to be measured in terms of future production.

If that price goes down or if the tax effects adversely affect that future production, there is going to be much less rate of return, much less investment. As this decrease in rate of return multiplies over the years, you will see some people who no longer make that investment.

It is a real economic investment and not one that is just made for the tax benefit.

Mr. **Braden**. I would like to share in that.

I have had a number of experiences, Senator, the same as yours, that there are an awful lot of people who feel that people make these investments only because the tax incentives are available, because they attempt to see, as a news type, or attempt to deal with the fringes of the area, and they do not see the basic transactions that occur.

It is very difficult to get the point across that as long as tax rates are below a hundred percent, people are in fact risking substantial amounts of money in order to generate any tax deduction as a result of oil and gas investment.

That is substantial amounts of their own individual capital, and I think it is very unfortunate that people do not realize that, that that point does not come across to many people who are in policy-making decision positions.

Sentaor **Nickles**. In the accounting field there are several different pieces of the Treasury proposal that pertain to oil and gas.

Most of the witnesses today, I think, have mentioned they felt that the most Draconian of those would be losing the expensing of intangible drilling costs.

Do you agree with that, as compared to, say, repealing the depletion?

Mr. **Braden**. I think it depends on where you are in the petroleum industry.

In general, you know, the Treasury estimates that probably only about 25 percent of the total net production is held by persons who are either independent producers or royalty owners, and the rest is attributable to integrated companies who are not now eligible for percentage depletion, although all producers are eligible for the deduction for intangible drilling costs, although integrated companies have to capitalize 20 percent down.

So, in that respect, all production and all producers would be affected by intangible drilling cost deduction. But for many people, the allowance of percentage depletion is just as important an investment incentive as the intangible drilling costs.

Senator **Nickles**. If independents were forced to capitalize a part of their intangible drilling costs in a similar manner as the integrated companies, how damaging do you think that would be?

Mr. **Riley**. It would depend upon the financial stability of each independent.

Those who could weather that amortization period, 4, 5, or 10 years so that they get the pool built up so that each year their amortization is approximately equal to their IDC expenditures, 10 years from now they will be in the same position they would be otherwise.

But in the meantime, there will be such an elimination of those people who do not have the financial stability to weather that period of time. That is why I suggested that if that period could be shorter for the exploratory wells, if the administration wants to encourage, while at the same time providing an investment tax credit, that would certainly offset that devastating effect.

Then if you wanted to give a lesser credit for the development wells in that same field, and a longer period of writeoff, that would still encourage exploration, providing the immediate tax relief for those intangible drilling costs that they incur, that perhaps would help to encourage people in the industry and let those people in the more marginal situations survive that initial 5-year period.

Senator **Nickles**. You also mentioned, Mr. Riley maintaining percentage depletion for stripper wells.

The integrated companies do not have percentage depletion; is that correct?

Mr. **Braden**. Yes.

Mr. **Riley**. That is correct.

Senator **Nickles**. I thought I heard that. But your argument was if changes are going to be made in percentage depletion, certainly do not change it on the stripper wells.

Mr. **Riley**. Yes. Those wells have such a marginal value anyhow, that if you take away any of the factors in the calculation of return on that investment or return from that well so that it is less economical, those wells will probably be plugged and abandoned.

They typically have a very high operating cost and they also typically, all the lease-hole costs have been written off in years past, so we have nothing here to cost amortize. So, that would not be affected. Likely, these wells would be abandoned.

I think we had testimony to that earlier this morning that there are a large number of wells and a great volume of production that would be lost in this country forever. You would not be able to go back into these wells and make them productive. Once that well is abandoned, it will be lost forever.

Senator **Nickles**. Gentlemen, I appreciate very much your cooperation and communication.

We have had a request from one additional person to speak before the committee.

Is Brian Egolf here?

Mr. **Egolf**. Yes, I am here.

Senator **Nickles**. Thank you very much.

STATEMENT OF BRIAN F. EGOLF, PRESIDENT, PETROLEUM INVESTMENTS, LTD., OKLAHOMA CITY, OK

Mr. EGOLF. I appreciate the opportunity, Senator, to make this time available to me.

To talk about all the issues that all the preceding people have spoken about this morning and this afternoon about IDC's, depletion, would be going over the same subject yet another time.

What I would like to address today is a part of the Treasury proposal that really for the most part has been overlooked, and I believe it is as important as any other of the various provisions that are included in the Treasury proposal.

The U.S. Treasury tax reform proposal now before President Reagan for consideration as a package contains a specific proposal to tax all limited partnerships with more than 35 limited partners as corporations.

Thus, 50 percent of all limited partner cash-flow distributions would be subject to the new 33 percent flat corporate tax rate, and 100 percent of those distributions would be subject to the new 35 percent income tax rate for single taxpayers with income of more than $38,000, and married taxpayers with income of more than $63,000; and an effective tax rate of 51.5 percent would apply.

Oil and gas cash flow distributions would be particularly hard hit, since the Treasury proposes to eliminate deductions for intangible drilling costs, investment tax credits, and production tax credits, as well as repealing the 15 percent percentage depletion allowance.

Thus, energy, oil and gas, geothermal and coal, real estate, R&D limited partnerships are virtually threatened with extinction, and the source of financing that they represent would be denied to independent oil, gas, geothermal operators, as well as real estate developers and a wide variety of R&D companies.

There are wide repercussions of the 1.5 million limited partnerships which file tax returns annually and have more than 35 limited partners. More than 1,000 are service related; more than 3,200 of those are finance or insurance LP's; more than 200 are manufacturing LP's; and more than 170 are agricultural LP's.

To point out one or two specific points in the Treasury proposal: The Treasury proposal to tax large partnerships as corporations reflects a policy that aims at eliminating all partnerships with limited liability.

The result is that all business activity would be directed toward general partnerships and/or corporations.

It is the intention of the present law and the new Treasury proposal to encourage decisions to be made on business merit rather than motivating grounds. Yet the proposal would now force taxpayers to limit investment in the hydrocarbon industry to stock purchases.

Direct investment in oil and gas interests, even on a small scale, would ultimately be foreclosed.

Additionally, large partnerships are traditionally more important vehicles for capital formation. In high-risk activities, such as oil and natural gas exploration, a limited partnership is the only entity that provides a proper balance between risk and reward to the investor.

As far as loss of the productive activity, the Treasury states that the activity of large partnerships is, quote, not desirable. However, oil and gas partnerships either explore or develop new domestic reserves, thus reducing dependence on imports.

They also provide a source of liquidity and add stability in the volatile petroleum markets.

Investors are not primarily motivated by tax considerations, but by the return on their investment. To illustrate this, during the past 3 years, in response to falling prices and relatively high interest rates, public investments in oil and gas drilling partnerships have declined almost 75 percent, while the tax treatment of depletion and intangible expensing has remained the same.

In conclusion, any changes in Government policy at this time should encourage direct investment through limited partnerships. In the oil and gas industry, limited partnerships are an essential element in funding exploration and production efforts.

Any reduction of incentives or restraint placed on the partnership arrangement will curtail the search for essential new domestic oil and natural gas reserves and be a threat to our national security.

The current tax laws affecting partnerships must be maintained.

Further, it was kind of interesting to me to note in this morning's paper the State has passed a law to prevent takeovers of corporations, or to make it more difficult, involving assets in excess of $75 million.

Yet my company, as a publicly-traded limited partnership on the New York Stock Exchange, we are involved in an exchange offer involving $108 million of Oklahoma's assets, or assets within the State, and the Government is trying to do the same thing to us that would occur in a takeover, dissolution and free distribution of our assets.

Thank you.

[The prepared statement of Mr. Egolf follows:]

POSITION STATEMENT

Treasury Proposal - Tax Simplification

By: Brian F. Egolf, President
Petroleum Investments, Ltd.

ISSUE

Treasury Proposal - Tax Simplification

Specific Provisions:
Eliminates:
(1) Accelerated Depreciation
(2) Investment Tax Credit
(3) Capital Gains Exclusion
(4) Intangible Drilling Cost Deductions
(5) Percentage Depletion Allowance, and
(6) Would tax all limited partnerships with more than 35 limited partners as corporations

Legislative History

Congress has thoroughly examined these issues since 1976 when they were first proposed by the Carter Administration. After hearings and discussions, the conclusion was that adoption of such proposals was that adoption of such proposals would be unwise. Over the past six years these concepts have been resurrected with little support or change in Congress' original conclusions.

Discussion

Elimination of Percentage Depletion and Intangible Drilling Cost Deduction

The industry has been under pressure from a sliding economy and reduced demand for energy and subsequent rapidly deteriorating prices both on a domestic and an international level. The net effect of these rather glaring market deficiencies has been to defer if not totally redirect the normal availability of investment capital for independent investment in oil and gas exploration and development.

In tandem with these very serious market problems, the industry has had to deal with a very hostile political environment generated by a very misguided Treasury Secretary, Donald Regan. More specifically, the administrations new tax proposals are focusing on the elimination of sound business incentives which promote strong economic growth in our country. Within our "high risk" industry, the "depletion allowance" and the intangible drilling cost deductions are considered essential to attract the kind of capital that is necessary to provide healthy unleveraged growth for a business that is responsible for replacing and improving our country's energy reserves and engineering our country's energy independence which is vital to our National Security and important in controlling the exploding trade deficit.

Should these much needed incentives be eliminated, the results would be to:

- Reduce investment capital
- Reduce number of active companies
- Reduce jobs
- Reduce nations oil and gas reserves
- Reduce overall productivity of the energy sector
- Increase dependence on foreign oil

Presently, without the elimination of these important incentives, the real effect of this continued outside pressure on the industry from the administration and escalating, depressed market conditions has been to substantially reduce the numbers of smaller to medium size oil companies and effect a great centralization within the industry, toward the eventual existence of a handful of very large companies.

We are experiencing a reduction in the numbers of small to medium sized business and if these current trends are not reversed they will lead to the eventual existence of a handful of very large companies within each industry.

Independents, as a group, have survived because they perform many necessary functions, vital to the successful operation of the energy industry as a whole. In the past, as well as now, when the energy industry has come under attack, major oil companies and independents have coalesced in a united front to preserve the successful working relationships within the energy industry and insure that this country's energy needs are realized.

A long time before the Reagan administration, the free market forces within the energy business determined the importance, the necessity of the independent sector of the energy industry. The administration's economic policies that encourage centralization within industry can only be effective if we allow the government to regulate the small and medium sized companies out of business.

"Free markets" are the only markets we've known in this country.

Free markets are the rules and conditions that have governed business operations in this country for the last 60 years.

Changing those rules is "government interference" and "regulation."

Proposal to Tax Limited Partnerships as Corporations

The U. S. Treasury Tax "Reform" proposal now before President Reagan for consideration as a "package" contains a specific proposal to tax all limited partnerships with more than 35 limited partners as corporations.

Thus 50% of all LP cash flow distributions would be subject to the new 33% flat corporate tax rate and 100% of those distributions would be subject to the new 35% income tax rate (for single taxpayers with incomes of more than $38,099 and married taxpayers with incomes of more than $63,799) . . . an effective tax rate of 51.5%.

Oil and gas cash flow distributions would be particularly hard hit since the Treasury proposes to eliminate deductions for intangible drilling costs, investment tax credits, and production tax credits (and in the case of geothermal the 15% energy tax credit) as well as repealing the 15% percentage depletion allowance.

Thus energy (oil, gas, geothermal, coal), real estate and R&D limited partnerships are virtually threatened with extinction and the source of financing they represent would be denied to independent oil, gas and geothermal operators as well as real estate developers and a wide variety of R&D companies (e.g. Interferon research, solar cell research, high-tech research etc.).

There are wider reprecussions. Of the 1.5 million LP's which file tax returns annually (and have more than 35 limited partners) more than 1,000 are service related, more than 3,200 are finance or insurance LP's, more than 200 are manufacturing LP's, and more than 170 are agriculture LP's. Cable TV LP's are also threatened as are cattle feeding and commodities LP's.

The Treasury proposal for tax reform would treat limited partnerships with more than 35 limited partners as a corporation for tax purposes. General partnerships would not be limited in number.

The Treasury proposal to tax large partnerships as corporations reflects a policy that aims at eliminating all partnerships with limited liability. The result is that all business activity would be directed toward general partnerships and/or corporations.

It is the intention of present law and the new Treasury proposal to encourage decisions to be made on business merit rather than tax motivated grounds. Yet the proposal would now force taxpayers to limit investment in the hydrocarbon industry through stock purchases. Direct investment in an oil and gas interest, even on a small scale, would ultimately be foreclosed.

Large partnerships are a traditionally important vehicle for capital formation. In high-risk activity such as oil and natural gas and geothermal exploration, the limited partnership is the only entity that provides a proper balance between risk and reward for the investor.

Loss of productive activity. Treasury states that the activity of large partnerships is not desirable. Oil and gas and geothermal partnerships either explore or develop new domestic reserves thus reducing dependence on imports.

Investors are not primarily motivated by tax considerations, but by the return on their investment. To illustrate this, during the past three years, in response to falling prices and relatively high interest rates, public investments in oil and gas drilling partnerships have declined almost 75 percent while the tax treatment (depletion and intangible expensing) has remained the same.

In conclusion, any changes in government policy should encourage direct investment through limited partnerships and maintain incentives for capital formation. In the oil and natural gas industry, limited partnerships are an essential element in funding exploration and production efforts. Any reduction of incentives or restraint placed on the partnership arrangement will curtail the search for essential new domestic oil and gas reserves.

SPECIFIC ILLUSTRATION OF THE EFFECT TREASURY'S TAX SIMPLIFICATION PROPOSAL ON THE INDEPENDENT OILMAN

I CAN ONLY SPEAK FROM PERSONAL EXPERIENCE, BUT THERE ARE THOUSANDS OF INDEPENDENT OILMEN IN THE U.S. LIKE ME, AND IF THE SAME THINGS ARE HAPPENING TO THEM THAT ARE HAPPENING TO ME, THEN THE DOMESTIC ENERGY INDUSTRY IS IN SERIOUS TROUBLE.

To illustrate my position, I am General Partner of Petroleum Investments, Ltd. and have conducted successful private and public drilling programs since 1969, consistently ranking in the top five in the country in both capital raised and return on investment.

In the last 15 years my company has operated or participated in 1,656 wells accounting for total expenditures of $261,000,000 representing a significant part of the total well expenditures of over 1.7 billion dollars and has contributed over 20 million equivalent barrels of oil to our domestic energy reserves.

Of the original cost, my company has recovered $130,000,000 or approximately 50% with anticipated total return of 150%.

Given the high degree of risk and the rather modest return, incentives are essential to attract investment capital.

By eliminating the available investment incentives, my company will be deprived of a primary source of capital formation, namely, outside investor capital to finance ongoing drilling and exploration.

In addition to the limited partnership drilling programs, I am the President of Petroleum Investments, Ltd., one of four publicly traded limited partnerships on the New York Stock Exchange.

If the provision to tax partnerships with more than 35 limited partners as corporations is enacted, the trading value of my company's stock would depreciate in value in proportion to the newly applicable tax rate of 51.5% on distributions. The reduction in stock value would dramatically reduce my company's borrowing power, thus eliminating a secondary source of financing for ongoing drilling and exploration.

The reality of the present situation is that the very mention of the possibility that these various provisions of the Treasury's proposal for "tax simplification" might actually become law has had a serious, chilling effect on the oil and gas industry. Unless some definitive statements from the administration are received, the independent sector of the energy industry will suffer irreversible damage.

Senator NICKLES. Thank you, Mr. Egolf. I have a couple of questions.

The proposal only affects those limited partnerships with over 35 partners?

Mr. EGOLF. Over 35 partners, correct.

Senator NICKLES. How many did you say there were in this country?

Mr. EGOLF. One point five million limited partnerships that have over 35 partners.

Senator NICKLES. How many of those deal with oil and gas?

Mr. EGOLF. Offhand, I do not know, Senator. I would guess that probably the majority of those do.

Senator NICKLES. Is yours oil and gas related?

Mr. EGOLF. Yes, it is.

Senator NICKLES. Could you tell me how you got the 51 percent effective rate?

Mr. EGOLF. The tax effects that were presented to me state that 50 percent of all limited partner cash flow distributions would be subject to the 33-percent corporate rate.

In other words, they would be taxed at 33-percent corporate level.

Then as the distributions would be made to the limited partner investors, they would again be taxed at the new 35-percent income tax rate.

Senator NICKLES. OK. I understand. You would also have the 50 percent for the divided.

Mr. EGOLF. Exactly. The limited partnerships, the publicly-traded limited partnerships presently disburse their distributions tax free to the shareholder.

Senator NICKLES. Well, I thank you for bringing that in. I think you are right. It is something that should be brought in to the committee, and I appreciate your comments.

To all of our panelists and guests today, we appreciate your participation. I hope and I believe that this will help build the record.

It bothers me to see proposals being made without realizing what type of economic impact they would have on States and communities and on industries.

Too many times we have seen legislation passed with very little input from the real world. So, again, I appreciate everyone's presentation today.

There is a sign-up sheet in the back for those who are interested in a copy of the transcript of the hearing. It will be available after it is printed. If you are interested in this or in other issues, we will continue to work with you in the future.

Thank you very much.

The hearing is adjourned.

[Whereupon, at 1:15 p.m., the hearing adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

American Petroleum Institute
1220 L Street, Northwest
Washington, D.C. 20005
202-682-8100

Charles J. DiBona
President

February 5, 1985

The Honorable Don Nickles
United States Senate
Washington, DC 20510

Dear Senator ~~Nickles~~: Don

I am pleased to know of your opposition to provisions in the Treasury Department's Tax Simplification plan which would repeal intangible drilling costs and percentage depletion.

The American Petroleum Institute (API) agrees with you that these proposed changes would have disastrous effects, not only for the energy industry, but also for the national economy and national security. Your efforts in expressing these concerns directly to the Department of Treasury, and other officials in the Reagan administration are greatly appreciated.

I have written President Reagan enumerating the many adverse consequences associated with the Treasury proposals. Enclosed is a copy of my letter. API has also contacted other administration officials at the Department of the Treasury, White House and Department of Energy.

API, along with its member companies, is developing additional information about the effects of the proposals on the oil and gas industry and on the U.S. economy. As this information becomes available, we will be discussing it with the Department of the Treasury and with others in the administration. Also, we will keep you abreast of these developments.

I look forward to working with you on this important matter.

Sincerely,

Charlie

Enclosure

American Petroleum Institute
1220 L Street, Northwest
Washington, D.C. 20005
202-682-8100

Charles J DiBona
President

January 17, 1985

The President
The White House
Washington, D.C.

Dear Mr. President:

We in the petroleum industry would like to call to your attention some widespread misconceptions regarding the state of energy in the United States. There are dangerous trends in America's supply outlook which are being masked by the current world excess capacity.

Many erroneously assume that the present worldwide "oil glut" will continue indefinitely.

In fact, as you know, the United States outlook for oil and gas supplies is already changing, for the worse. Domestic drilling and exploration are down. Domestic consumption is rising. Domestic reserves are falling. The favorable trend toward reduced dependence on foreign oil that your administration has achieved was clearly reversed in 1984.

One ominous indicator is that imports in 1984 were up about 10 percent over the previous year, and now constitute more than one-third of our total consumption -- approximately the same percentage that existed at the time of the 1973 gasoline lines and crisis.

This changing situation in America is also being experienced in some other oil-importing countries, and this trend inevitably will put downward pressure on the current worldwide excess of capacity. It is impossible to forecast whether that excess capacity will shrink to dangerously low levels during your administration or that of a successor, but there is little question that it will happen. Without careful measures being taken, the nation could be back where it was in 1973.

While the petroleum business is inherently cyclical, we are confident that the industry can help continue the nation on a course toward a more secure energy future -- given the decontrol measures you boldly executed shortly after taking office, given the leasing policies your administration has designed, and given other positive steps taken by your government over the last four years.

But petroleum companies of all kinds, large and small, integrated or independent, agree that our contribution to a stronger energy posture will be reduced greatly by the tax proposals put forward for your consideration by the Treasury Department.

Analysts generally agree that the Treasury staff's recommendations would result in a significant shift of investment away from development of America's basic domestic energy resources. In fact, that is the Treasury staff's stated intent. But it is perhaps less understood that the proposals constitute a reversal of policies that you developed and supported in order to encourage investment in energy and other production.

Although the Treasury proposals are said to be even-handed, the results would be unfavorable to the economy and to our energy security. We believe the effect on the nation would be to:

- cause an immediate decline in domestic oil and natural gas exploration. In consequence, based on current company estimates, production by the end of the decade would be expected to decrease by the equivalent of 1 million barrels of oil a day -- the result of decreased capital availability and reduced incentives. That amount of fuel, either added to or subtracted from world supplies, could have a substantial effect on world prices. We believe the domestic production decline caused by the tax proposals could reach 1.5 million barrels a day by 1995.
- add at least this 1.5 million barrels a day by 1995 to the already increasing oil imports. This would result in imports greater than 50 percent of national consumption. An upward trend in U.S. petroleum imports would affect world oil prices and thus affect the amount Americans -- and other nations important to us -- pay for their energy.
- adversely affect America's national security as well as its ability to conduct foreign policy.
- adversely affect the U.S. balance of payments.
- return to OPEC nations a substantial amount of the influence they formerly held over the American economy.
- significantly reduce real gross national product and increase the unemployment rate during the rest of the 1980s, according to widely used economic models.

- severely hurt many non-petroleum industries that are heavily dependent on drilling operations. Many thousands of companies -- which, collectively, employ hundreds of thousands of people all over the country -- are directly or indirectly tied to oil and natural gas operations. Still other industries are affected by the price and availability of fuel.

As we all understand, the Treasury staff's approach would be subject to many changes in the Congress. Experience tells us that any "even-handedness" is likely to disappear -- that the most damaging elements of the plan could be retained or expanded and the rest removed.

If this worse eventuality happens, the loss of domestic petroleum production could approximately double the amounts mentioned above.

The Treasury staff proposals, as they relate to the oil industry, appear to be based in part on an assumption that oil companies do not now pay a "fair share" of federal taxes. We would point out that, in fact, the oil industry pays double the average of other industries. In the last four years for which data is available, through 1983, some 44 percent of oil company pre-tax income was paid to the federal government in taxes, compared with 23 percent for other manufacturers.

We appreciate your taking the time to consider these points. As you know, we have supported your earlier tax initiatives, and we wish to help in your efforts this year to find a truly effective tax-simplification package.

Sincerely,

Charles J. DiBona

Official Committee File

SENATE COMMITTEE ON
ENERGY [illegible]

BALLEW OIL & GAS PRODUCTION CO.
[illegible]
HOLDENVILLE, OKLAHOMA 74848
[illegible]

February 15, 1985

Mr. David Doane, Senior Counselor
U. S. Senate Energy
and Resources Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Doane:

I am a very small independent oil and gas producer in the State of Oklahoma. I drill four to five wells per year. If the Treasury Department's current re-vamp of the federal income tax system continues in the direction of deleting intangible drilling costs, depletion and depreciation, its effect will be catastrophic to our business. With the decline in domestic crude oil prices, the normal high risk of oil and gas exploration and the possible removal of sheltered risks capital, our operation will be reduced to, maybe, one well per year. If you multiply this problem by the thousands of independent operators nationwide, what then, will be our dependency position on foreign crude in the very near future?

I urge you to consider the ramifications, not only to my small business, but the impact current tax proposals will have on our nation and its security.

Sincerely,

Jack L. Ballew

Jack L. Ballew
President

JLB/jm

Devon
ENERGY CORPORATION

February 19, 1985

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
MAR 0 [illegible]
WASHINGTON, D.C. 20510

Mr. David Doane
Senior Counsel
United States Senate Energy
and Natural Resources Committee
United States Senate
Washington D.C. 20510

Dear Mr. Doane:

Attached is a copy of my recent letter to Acting Assistant Secretary for Tax Policy, Ronald A. Pearlman, describing the potential effects on my company, Devon Energy Corporation, of the Treasury Department's proposals for tax simplification. Should these proposals become law, they would be extremely damaging to Devon and the entire domestic petroleum industry.

Please include my letter to Mr. Pearlman for the record as discussed by the attached letter from Senator Nickles.

Thank you very much for your help. Please contact me if further data is needed.

Very truly yours,

DEVON ENERGY CORPORATION

Carl E. Barber
Vice President

CEB:jdc

cc: The Honorable Don Nickles

Attachments

1500 MID-AMERICA TOWER • 20 NORTH BROADWAY • OKLAHOMA CITY, OKLAHOMA 73102 • 405/235-3611 • TWX 910-831-3277

Devon
ENERGY CORPORATION

February 8, 1984

Mr. Ronald A. Pearlman
Acting Assistant Secretary for Tax Policy
Department of Treasury
Washington, D. C. 20220

Dear Mr. Pearlman:

With great concern I have analyzed the Treasury proposals for tax simplification in relation to the effect of those proposals on the domestic oil and gas industry and, more specifically, on Devon Energy Corporation. Those proposals, if enacted, would have a disastrous impact on our ability to drill for and develop new petroleum reserves and imperil the livelihood of our employees.

For the most recent year for which audited numbers are available, 1983, Devon spent a total of $8.2 million in finding and developing petroleum reserves. Of that amount, over 40% was funded by outside investors. Elimination of the incentives currently embodied in the Internal Revenue Code to encourage exploration for and development of domestic reserves would have reduced the amount available from outside sources for Devon's drilling and development efforts by $3.3 million.

If the Treasury proposals had been in effect during 1983, Devon would have paid an additional $1.6 million in Federal income taxes. Thus, the loss of outside investor funds coupled with the payment of additional income taxes would have reduced Devon's funds available for finding oil and gas by $4.9 million or almost 60% of our total drilling budget.

In years 1978 through 1982 Devon raised in excess of $60 million from outside sources. As a result of these expenditures, Devon has developed oil and gas reserves remaining at the beginning of 1984 of 425,000 barrels and almost 18 billion cubic feet of gas. Without this outside investment, encouraged by the tax incentives which the Treasury proposes to eliminate, the location and development of these reserves would not have been possible.

1500 MID-AMERICA TOWER • 20 NORTH BROADWAY • OKLAHOMA CITY, OKLAHOMA 73102 • 405/235-3611 • TWX 910-831-3277

Currently, Devon employees a total of 150 people in our offices in Colorado, West Virginia, Louisiana, and Oklahoma. Most of these people owe their jobs to the fact that Devon has been successful in attracting and prudently investing outside funds. The elimination of access to these funds resulting from the proposed changes in the current taxation of oil and gas exploration and development activities would jeopardize many of these peoples' jobs.

Even with the current incentives in place Devon stills pays more than its fair share of Federal tax. For example, in 1983 Devon paid a total of $814,000 in windfall profit tax. For that year, our taxable income was only $1.8 million.

Devon Energy Corporation is not atypical as an independent producer of domestic oil and gas. The debacle described above for Devon would be repeated thousands of times across the nation as other oil companies succumbed to the effects of this new law. We respectfully request, therefore, that you consider rescinding those provisions of the Treasury proposal which would have such a devastating impact on the domestic petroleum industry. I believe that this vital industry, as we know it, would cease to exist should those proposals become law.

Very truly yours,

DEVON ENERGY CORPORATION

Carl Barber

Carl E. Barber
Vice President

CEB/mmw

cc: The Honorable Don Nickles, U. S. Senator

Official Committee File

RESOURCES

FEB 19

LAW OFFICES
BAY, HAMILTON, LEES, SPEARS & VERITY
501 NORTHWEST THIRTEENTH
P. O. BOX 61190
OKLAHOMA CITY, OKLAHOMA 7314
405-235-5605

ARTHUR S. BAY
ANDREW L. HAMILTON
DONALD H. LEES
LARRY M. SPEARS
G. L. JIDGE VERITY
[redacted]

GEO. L. VERITY
OF COUNSEL

February 12, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy and
National Resources Committee
United States Senate
Washington, D.C. 20510

Re: Tax Simplification

Dear Mr. Doane:

You might chalk this letter off as just another piece of "nut mail". I was invited to send it by Senator Nickles in a form letter addressed to "Dear Energy Friend". Although I have a small amount of royalties, I choose not to be categorized in that fashion.

Actually, I am a free market nut. I feel about tax simplification like I did, at one time, about prohibition in Oklahoma. The only way we got rid of prohibition in Oklahoma was to seal the borders and truly dry up the flow of bootleg liquor into the State. Only when Oklahomans got dry enough did they see fit to vote out prohibition.

In like manner, I believe the only way Americans will do anything about outrageous taxes is to seal off the tax loopholes. If we are all made to equally bear the tax burden, then, and only then, will something be done about outrageous government expenditures and waste.

Yours truly,

ARTHUR S. BAY

ASB/wc

cc: Senator Don Nickles
United States Senate
Washington, D.C. 20510

Liberty
A Bank of Mid-America

WILLIAM M. BELL
Vice-Chairman

February 8, 1985

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
MAR 0 [illegible]
WA[illegible]

Mr. Ronald A. Pearlman
Acting Assistant Secretary
for Tax Policy
Department of Treasury
Washington, D.C. 20220

Dear Mr. Pearlman:

I want to share some of my concerns regarding the impact of the proposed energy industry tax plan on this region's economy. The Oklahoma Congressional delegation and our Governor have provided you with figures on the negative impact this tax plan will have on the energy industry. My concern is for the negative repercussions this tax plan will have on the other segments of our regional economy and its cost to the Treasury Department.

Everyone in this region, especially merchants, realtors, home builders, banks, and savings and loans, would suffer as a result of the harm this plan will cause the energy industry. The Federal Reserve Bank of Kansas City in its publication Economic Review, December 1984, noted this region's slow growth is due to the dependency of the economy on energy. It further outlined the negative implications this dependency has on many other segments of our economy. This region is already lagging the nation in terms of economic recovery. The tax plan for the energy industry will be a killer blow to this region's economy til the turn of the century.

I ask you to analyze the cost of this tax-plan to the Treasury Department in regard to the added strain on the banking industry

THE LIBERTY NATIONAL BANK AND TRUST COMPANY OF OKLAHOMA CITY • P.O. BOX 25848 • OKLAHOMA CITY, OKLAHOMA 73125

Mr. Ronald A. Pearlman
February 8, 1985
Page 2

in this region if more energy companies fail. Who is going to prop up all the banks that will fail? This attempt to collect tax from the energy industry might well cost the federal government more in the long run through other agencies like the FDIC and FSLIC.

I also ask you to work with our congressional delegation to ensure that the noble cause of reducing and hopefully eliminating the federal deficit does not destroy our region's economy.

Thanks for your time and consideration.

Sincerely,

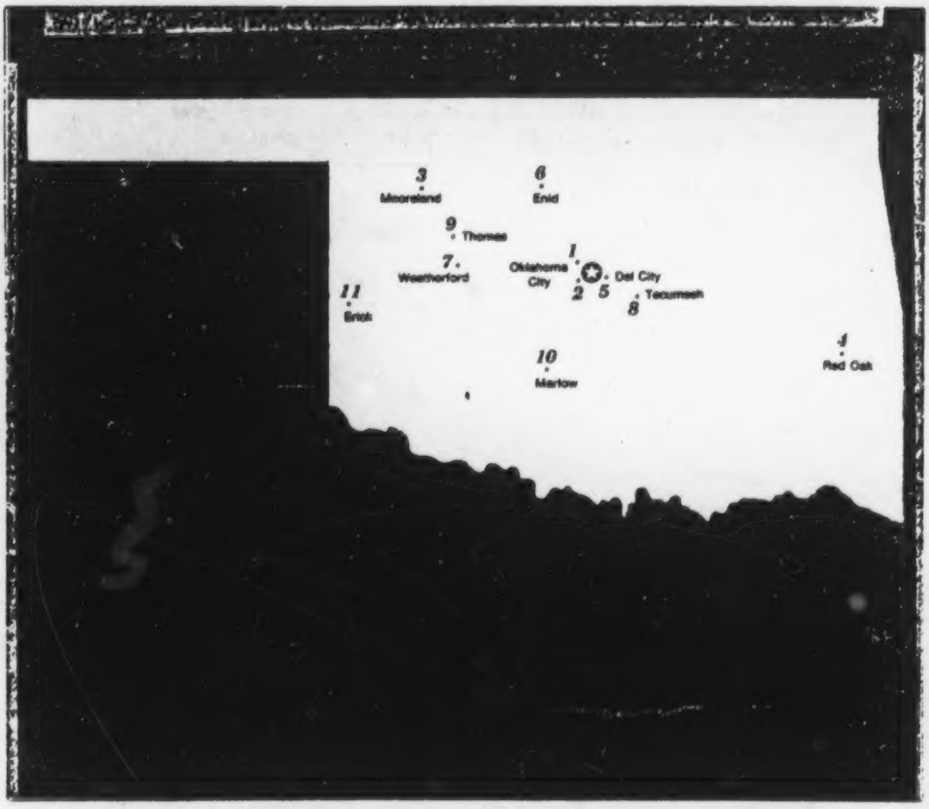
Encl.

cc: Oklahoma Congressional Delegation

cc: Mr. David Doane

THE DAILY OKLAHOMAN

FRIDAY, FEBRUARY 8, 1985


3
Mooreland
6
Enid
9
Thomas
7
Weatherford
1
Oklahoma City
2
5
Del City
8
Tecumseh
11
Erick
10
Marlow
4
Red Oak

Bank Fails Farmers National Bank in Erick was closed Thursday by regulators, who cited loan losses. The bank's assets were purchased by another bank in Erick and will reopen today in the same location a a branch to First American Bank. It was the 11th bank since July 1982 to close in Oklahoma. Story, Page 1.

THE DAILY OKLAHOMAN

FRIDAY, FEBRUARY 8, 1985

Erick Bank Closes Doors

By Kevin Laval

Farmers National Bank in Erick was declared insolvent and closed by federal bank regulators Thursday.

But Erick Bancorporation Inc., the holding company owning the other bank in the small western Oklahoma town, bought the failed institution's good business, which it will use to open a branch of First American Bank this morning.

All deposits are protected in the deal, including those exceeding the $100,000 insurance limit.

The U.S. Comptroller of the Currency, which regulates national banks, closed Farmers National shortly after 3 p.m. Dean DeBuck, a spokesman for the comptroller, would say only that loan losses had exhausted the bank's capital.

Capital is the owners' investment in a bank. Regulators require banks to maintain levels of capital that will allow them to absorb loan losses and continue operating soundly.

Federal Deposit Insurance Corp. spokesman Alan Whitney said FDIC files noted inadequate supervision and rapid expansion of the loan portfolio at the failed bank. The FDIC, as insurer, assumes the remains of failed banks.

The management of Farmers National was not available.

Erick, population 1,375, is in Beckham County, about 10 miles east of the Texas border. It is in an area of the state that depends heavily on the faltering energy and agriculture industries.

Erick Bancorporation agent David Rainbolt said the FDIC solicited that company Tuesday for a bid for Farmers National's assets. Erick Bancorporation's was the only bid when the deadline passed Wednesday.

FDIC officials in Washington approved the bid shortly before 4 p.m. Thursday. In an emergency meeting Thursday, the Oklahoma State Banking Board approved an application by First American, a state bank, to open a branch in the former Farmers National office this morning.

Rainbolt said Erick Bancorporation bid a $56,000 premium to get the defunct bank's good business. Erick Bancorporation vice president Billy Blount said the firm is required to invest another $1.1 million of capital in First American to accommodate the added $16 million in deposits.

Before the deal, First American also had about $16 million of deposits. Whitney said Erick Bancorporation agreed to take $11,9 million of Farmers National's assets. But the company was not required to assume the failed bank's commercial loans and can return to the FDIC installment loans that prove to be problemed.

The FDIC gave the buyer $4.2 million in cash to ensure that the assets assumed equal the liabilities. The FDIC now will try to recover its costs by collecting on or selling the failed bank's questionable

See ERICK, Page 2

Other Bank Failures —Page 17

Erick

From Page 1

lendings.

Rainbolt said management will consider retaining the employees of Farmers National to work at the First American branch. He said about 10 were employed by the defucnt institution.

Farmers National was the sixth Oklahoma bank to fail in as many months. It and First National Bank in Woodline, Iowa, which also was closed Thursday, were the eighth and ninth bank failures in the United States this year.

BRACKEN
EXPLORATION
COMPANY

February 15, 1985

United States Senate
Committee on Energy and Natural Resources
Washington, D.C. 20510

Gentlemen:

Bracken Exploration Company is a small independent oil and gas operator, employing 110 Americans with an annual payroll of about $3,200,000. We spend, on behalf of ourselves and our partners, approximately $35 million per year exploring for oil and gas in Oklahoma and Texas. Approximately 80% of our budget for drilling comes from outside sources, including, for the last two years, limited partnerships having almost 100 partners in each partnership.

On November 27, 1984, the Treasury issued a detailed report entitled, "Tax Reform For Fairness, Simplicity and Economic Growth". Among the various changes recommended by the Treasury are three that are particularly adverse to the segment of the oil and gas industry utilizing capital raised from outside sources. Those changes are: 1. Elimination of the deductibility of intangible drilling costs. 2. Elimination of percentage depletion and 3. Taxation of limited partnerships with more than 35 limited partners as corporations.

You should be aware that any one of the above changes, irrespective of a reduction in tax rates, will be absolutely devastating to this Company and other members of our industry who are dependent upon outside sources for capital. It would be impossible for us to raise funds for exploration from any sources other than our own cash flow. As a result, it is probable that we would be required to terminate the employment of 75 to 80 employees and cut our drilling budget to $2.5 million or less.

I am sure you have heard from many companies concerning the first two items to be eliminated. Two years ago we elected to go to Shearson Lehman/American Express Inc., to raise drilling capital through private placement limited partnerships, since other sources had greatly diminished. Although it is extremely difficult to raise money that way, it seems to be our best source of drilling capital at the moment. Obviously, taxation of limited partnerships as corporations would also dry up that source.

5101 N. CLASSEN BLVD., SUITE 600 • OKLAHOMA CITY, OKLAHOMA 73118 • (405) 840-5541

As you are aware, exploration in Oklahoma is done primarily by independents such as Bracken and the impact of any of the changes recommended would totally destroy the economy of Oklahoma.

We desperately need to preserve the incentives to drill for oil and gas in this country. Please do not let other members of Congress lose sight of the fact that this nation is dependent upon foreign sources for its crude oil and that the continued development of domestic sources is vital to our defense as well as our economy.

Very truly yours,

Barth W. Bracken
BARTH W. BRACKEN
President & Chairman of the Board

BWB/bsb

Official Committee File

Gladys Chastain
8214 E. 32 Place
Tulsa, Okla 74145

Feb. 13, 1985

Mr. David Doane
Senior Counsel
United States Senate Energy & Natural Resources Committee
United States Senate
Washington, D.C. 20510

Dear Sir:

I am an elderly lady who owns a few royalties and mineral rights. They are not much, but I depend on them for my livlihood.

Such a change would drastically harm not only the economy, but my income and many other people in my age bracket who depend on oil production to help them to buy food and keep a roof over their heads.

Sincerly,
Gladys Chastain
Gladys Chastain

A.H.

SENATE COMMITTEE ON
ENERGY AND [illegible] RESOURCES
FEB [illegible]

NORTH
STAR
EXPLORATION COMPANY

February 18, 1985

Mr. David Doane
Senior Counsel
United States Senate Energy and
  Natural Resources Committee
United States Senate
Washington, D.C. 20510

RE: Written Comments on Impact of Treasury Department's Proposed Changes in Oil and Gas Taxation Before the United States Senate Energy and Natural Resources Committee

Dear Mr. Doane:

As a small independent producer of oil and gas, we would like to offer for your consideration and that of the committee's our opinions concerning the above matters. We understand legislation is currently being considered which would either repeal or significantly change the following as they apply to the oil and gas industry, to-wit:

1. Oil depletion allowance
2. Deductibility of intangible drilling costs
3. Limited partner "tax shelters" used to raise drilling capital

COMMENTS: The smaller independents in the industry rely heavily on raising outside capital for drilling purposes. Because of the high risks of the oil and gas business, this capital is very difficult to obtain. The tax incentives listed above, which have been granted by Congress in recognition of this problem, are essential for the smaller independents, such as our company, remaining in business. Without these tax incentives, the sources of capital will, for all practical purposes, dry up. The larger elements of the oil and gas industry do not rely on these incentives since they are able to fund their exploration activities from their substantial cash flows and other sources of capital.

3904 PARKLAWN DRIVE • MIDWEST CITY, OKLAHOMA 73110 • 405/733-8841

Mr. David Doane
Page 2
February 18, 1985

The industry is already in a very depressed state with oil and gas prices continuing to decline. The Treasury's plan has caused numerous investors to stay on the sidelines to await the outcome of the uncertainties. This action has further restricted our ability to raise the necessary risk capital for our operations. Congressional passage of these proposals will have, in our opinion, the following immediate effect on our business, to-wit:

1. Dry-up risk capital for exploration and development

2. Result in numerous companies in the oil and gas industry failing

3. Loss of many jobs in all oil-producing states

4. The role played by the smaller independent companies to reduce our dependence on foreign crude will be greatly diminished

We do not perceive any of these proposed actions as friendly to our industry and view them as expressly discriminatory against the smaller producers like ourselves. Please do not change these items of our tax code.

Thank you for your consideration.

Sincerely,

Mark D. Coldiron
Executive Vice President

MDC:dm

cc President Ronald Reagan
   The Honorable James Baker
   The Honorable David McCurdy
   The Honorable Mickey Edwards
   The Honorable David Boren
   The Honorable Don Nickles

CECIL L COOK
[illegible] S GAYLORD ST
DENVER CO 80210

Feb. 14, 1985

Official Committee File
SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
FEB 19
WASHINGTON, D.C. 20510

Mr. David Doane, Senior Counsel,
U S Senate Energy and Natural Resources Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Doane:

I have been invited by Senator Don Nickles, US Senator from Oklahoma, to submit comments and to attend the hearings in Oklahoma City regarding the Treasury Departments proposed changes in Oil and gas taxation designed to lower the tax rate and broaden the tax base.

I will not be able to attend the hearings, but would like to submit some comments for your consideration. I grew up in Oklahoma, right in the middle of several oil Booms, so I am not unfamiliar with this proposal. I worked 36 years for a Major Oil Company and am now retired, living on my oil Company pension and SS (which I had bought), and do not have to draw welfare, old age assistance, or any of the other government programs.

Both of these proposals, if permitted to become law, will contribute to the complete upheaval of present policies and practices that have stood the test for these many years.

The capitalization of intangible drilling costs would dry up funds needed to continue operations and not be it up-written on return by depreciation.

Mr. David Doone
Washington DC 20510

The percentage depletion provision, now provides for a return on investment based on the life of well and not on money actually spent; however, this life may be 2 Months or 20 years. There has to be some return for the risk involved.

The present handling has stood the test and has permitted private enterprise to provide for those of us who have been loyal to reap some of the rewards without dipping into welfare and social programs and competing with millions of other people who are continually licking at the Welfare trough, medicaid, and others.

This system has stood the test; is handled completely within the law; without government meddling to any great extent.

Why is it that lawyers, lawmakers, and politicians have to tear up a good thing that costs them nothing in order to make waves.

Hope these comments will assist you in your quest for the right thing.

Sincerely,

cc: Mr Don Nickles
United States Senator from Oklahoma

DANCO INC.
P.O. Box 608 • Bixby, Oklahoma 74008 • (918) 366-4453

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
MAR [illegible]
WASHINGTON, D.C. 20510

February 22, 1985

Mr. David Doane
United States Senate Energy & Natural Resources Committee
United States Senate
Washington, D.C. 20510

Dear David;

I am sorry that I missed the February 15th hearing that Senator Nickles chaired in Oklahoma City on the proposed changes in oil and gas taxation.

You have my support in your attempt to convince the Treasury Department that any change in the taxation of intangible drilling costs would be devastating to the independent oil producers. This could also hurt all other types of business which are directly related to the independent producers.

I hope they are convinced this would not be the right action to take.

Sincerely,

Joe Daniels

Joe Daniels
Vice President

"SERVING THE OIL & GAS INDUSTRY"

February 12, 1985

The Honorable Don Nickles
United States Senate
215 Dean McGee Ave.
Room 820
Oklahoma City, Okla. 73102

Dear Senator Nickles:

Attached please find a copy of a letter from the Chairman of the Board of our parent company, Standard Oil Company (Indiana), to Energy Secretary Hodel.

This letter outlines the position of Amoco Production Company with regard to the Treasury's Department tax proposal.

We appreciate very much you bringing this matter to Oklahoma City and offer our assistance to you in any way possible.

Thank you very much.

Sincerely,

Jim R. Dolph

Jim Dolph
Attachment

Standard Oil Company (Indiana)
200 East Randolph Drive
Chicago, Illinois 60680

Richard M. Morrow
Chairman of the Board

December 21, 1984

Mr. Donald P. Hodel
Secretary of Energy
U.S. Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585

Dear Mr. Secretary:

Thank you for the opportunity to provide our thoughts concerning the tax proposals contained in the Treasury report "Tax Reform for Fairness, Simplicity, and Economic Growth," and their potential effect on the oil and gas industry. While I commend the Treasury's goal of making the federal income tax system more equitable and less complex, I have serious reservations about the "price" the oil and gas industry, and ultimately the nation, will have to pay as a result of some of the tax code changes embodied in the Treasury tax report.

I know you were made aware of many of the generic concerns of the oil and gas industry at the recent National Petroleum Council meeting. I must echo those apprehensions. The country has been enjoying stable energy supplies and prices, which have helped bring inflation under control and bolster the economic recovery. Absent prudent foresight, however, tomorrow's energy picture could change dramatically.

In the longer-term, industry trends portend declining domestic reserves and increasing imports of crude oil and petroleum products, and thus, the reoccurrence of the economic and national security problems that we have worked so hard to overcome. The Treasury proposal would accelerate those trends. Government energy, environmental, and tax policies must reflect the national importance of a healthy and stable domestic energy industry.

The wide-sweeping nature of the Treasury tax plan has made it difficult to complete any comprehensive assessment of its effects to date, but preliminary analyses point to some very serious problems. My comments focus on two areas: 1) the consequences of the Treasury plan on the corporate sector generally, and 2) the effects on the petroleum industry specifically.

The effect of the Treasury tax proposals would be to increase corporate taxes 25 percent in FY '86 to 37 percent in FY '90. That is, total corporate tax payments would increase from about $87.9 billion to $110.1 billion in FY '86, and from $122.6 billion to $167.4 billion in FY '90. This will have a profound adverse effect on job creation. Increased business taxes will stifle economic growth and ultimately result in fewer federal tax revenues and increased outlays -- continuing a dangerous cycle that we are just beginning to break.

Federal tax policy has traditionally been used not only to raise revenues for the government, but also to promote social and economic goals. The Economic Recovery Tax Act of 1981 provided powerful tax incentives such as the Accelerated Cost Recovery System (ACRS) which spurred investment in productive plant and equipment, and is responsible for much of the current economic growth the country is presently enjoying. The erosion or repeal of ACRS and/or the Investment Tax Credit (ITC) simply runs counter to the nation's objectives of continued job creation and long-term economic growth, and could prove a high "price" for small gains in tax equity and simplicity.

The goal of the National Energy Policy Plan -- assuring an adequate supply of energy at reasonable costs -- can only be realized through government policies which promote the rational development and use of our domestic energy resources. However, certain elements of the Treasury tax proposal run counter to our national energy objectives. Proposed changes in the treatment of intangible drilling costs (IDCs) and dry hole expenses would discourage domestic exploration, thereby exacerbating the divergence between domestic reserve additions and production. Repeal of the ITC and the ACRS will also increase the cost and decrease the availability of capital which would have a negative effect on capital-intensive industries.

Specifically, our preliminary analyses of the Treasury tax plan indicate that the internal cash flow of the oil and gas industry will be reduced by approximately $81.2 billion over the 1986-90 period. If corporate tax rates are indeed lowered, and the cash dividend deductibility and Crude Oil Excise Tax phase-out provisions retained, oil and gas industry tax liabilities would be reduced by approximately $43.7 billion over the five year period. Thus, the Treasury tax plan results in a net $7.5 billion annual tax increase on the oil and gas industry, or $37.5 billion over the 1986-90 period.

Internally-generated cash flows represent only part of the total capital generated by the oil and gas industry. Estimates indicate that for each dollar of funds the petroleum industry generates internally, it will typically raise another 35 cents from external sources -- primarily through borrowings. If the industry is unable to generate the initial $1.00 internally through earnings and capital consumption allowances, lenders are unlikely to advance the 35 cents of additional borrowed funds. Hence, the total impact of the Treasury tax plan on corporate capital availability to the oil and gas industry will be more in the order of $10 billion per year. This decrease in capital availability will result in a reduction in 1990 domestic crude oil equivalent production in the order of 1.0 MMBD, thereby increasing dependence on imports to satisfy domestic demand.

The proposed tax changes will also negatively impact prospective internal rates of return from new investments in oil and gas projects. In a highly competitive market for investment capital, and a reduction in prospective investment profitability in the oil and gas industry accompanied by prospective improvements in after-tax investment returns in other lines of business, available capital will be diverted from marginal projects in the petroleum industry to other business investments. While not readily quantifiable, the expected deterioration in project rates of return will further decrease capital availability, depress domestic production and increase imports.

The decline in domestic production will worsen in the years beyond 1990 as the impact of reduced incentives and spending affect a greater and greater share of our domestic production base. Domestic oil and gas production would be expected to decrease by an oil equivalent of 1.5 MMBD by 1995 compared with production under current tax laws. Domestic net oil imports are expected to increase from about 5 MMBD in 1984 to about 8 MMBD in 1995 under current tax laws. With the Treasury proposal, U.S. oil imports by 1995 would be expected to increase to over 10 MMBD or 60 percent of domestic oil requirements. This doubling of imports from the current 30 percent to 60 percent of requirements would make the U.S. extremely vulnerable from both an economic and national security standpoint.

Estimated 1984 spending by the oil and gas industry (net of lease bonus payments to government) is roughly $50 billion, 80 percent of which will be in upstream spending to find and produce new oil and gas supplies. Industry spending commitments of this magnitude simply cannot be sustained in the face of a prospective cut of 25 percent or more in available capital and a sharp reduction in investment profitability.

The proposed reduction in the corporate tax rate, the treatment of dividends and phasing-out the ill-conceived Crude Oil Excise Tax represent significant steps toward long-term economic growth. I am concerned, however, that many of the favorable corporate tax provisions promised down the road in exchange for increasing business' tax burden in the short-term, will fall prey to changes in the political landscape. Without implementation of these tax reductions, oil and gas industry internal cash generation would be decremented by some $25 billion per year and U.S oil and gas production would be reduced by an oil equivalent of 1.8 MMBD in 1990 and 3.5 MMBD in 1995.

As evidenced above, the present Treasury tax package would be severely disruptive to the domestic energy industry, particularly in terms of domestic exploration. In the longer-term, it is not difficult to envision the adverse consequences of declining domestic energy supplies, increasing crude and petroleum product imports, and the implications for the nation's economic vitality and security.

Given the potential consequences of such broad changes in the Internal Revenue Code, I think it only prudent that the Administration proceed slowly and deliberately in assessing the ramifications. We must be sure that we are not establishing policies that will plunge the nation into serious energy supply problems.

Sincerely,

API STUDIES OF TREASURY TAX PROPOSAL

1. Review and assess the projected main economic effects of tax proposals provided by leading econometric models: Chase, DRI, and Wharton.

2. Construct detailed micro effects of tax proposals on the petroleum industry using the DRI model. Projections will be made of drilling, reserve additions, added imports, and impact upon supplier and related industries.

3. Support studies to illustrate the national security considerations resulting from lower U.S. oil and gas production. A contract has been signed with Henry Schuler (CSIS) and additional work will be done.

4. Review and consolidate company studies on tax effects and conduct API staff studies on major alternative tax proposals. Several discussion papers are now in preparation for review.

Official Committee File

William R. Gerber
403 Shady Creek
Woodward, Oklahoma 73801

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
FEB 19
WASHINGTON, D.C. 20510

February 11, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy and
Natural Resources Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Doane:

Please find enclosed a copy of a letter written to Mr. Pearlman, Acting Assistant Secretary for Tax Policy. I would appreciate it if you would enter my letter into the record for the field hearing chaired by Senator Don Nickles. This hearing is focusing on the impact of the Treasury Department's proposed changes in oil and gas taxation.

Thank you for your help.

Sincerely,

William R Gerber
William R. Gerber

WRG:cdd

Enclosure

William R. Gerber
403 Shady Creek
Woodward, Oklahoma 73801

February 4, 1985

Mr. Ronald A. Pearlman
Acting Assistant Secretary
for Tax Policy
Department of Treasury
Washington, D.C. 20220

Dear Mr. Pearlman:

I am an independent geologist whose livelihood depends on the oil and gas industry. There is a growing concern that the recent tax proposals offered by Mr. Regan will irreversably damage the industry. I can say this is justifiably true. The discussions of the recent proposals have already eliminated the usual year end increase in drilling activity in the state of Oklahoma. As a matter of fact, the active rig count decreased.

Mr. Regan's tax plan calls for the elimination of the immediate write-off of intangible drilling costs and the percentage depletion allowance (which has already been reduced in the past). These incentives are vital for the financial backing that comes from investors in privately owned drilling funds. As you know, many small independent oil companies are privately funded.

You are reported as saying, "The tax changes were meant to equalize taxes of all industries"; that would be agreeable if all industries encountered the same degree of risk when investing funds. During 1984, in Oklahoma, only 59 out of 285 new field wildcats encountered hydrocarbons in commercial quantities. A success ratio of 20.7 percent. In 1983, there were 384 wildcat tests. These were only 21.35 percent successful. Other exploratory wells such as zone discoveries and field extensions were only 33.77 percent successful in 1984. This compares to 39.63 percent success in 1983.

Mr. Ronald A. Pearlman
February 4, 1985
Page Two

As you can see, Mr. Pearlman, the overall success of finding new reserves has dropped. It has dropped because of the weak market demands and also because new reserves are becoming harder to find.

If the United States Government wants to continue this trend and guarantee that in the future the U.S. will depend more on foreign oil imports; they should pass the tax proposal.

For my future and the country's future, I hope you will consider Mr. Regan's tax proposal once again and treat the oil industry with fairness.

Sincerely,

William R. Gerber

William R. Gerber

WRG:cdd

cc: Mr. Don Nickles

Official Committee File
SENATE [illegible] TEE ON
ENERGY AND [illegible] RESOURCES

February 12, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy and
Natural Resources Committee
Unites States Senate
Washington, D.C. 20510

Re: Treasury Department Tax
Reform Proposal

Dear Mr. Doane:

Please refer to the following tax reform proposals pertaining to the oil and gas industry:

1) Repeal of the intangible drilling cost deduction
2) Repeal of the percentage depletion allowance
3) Dissallowment of dry hole cost deduction until a property is abandoned.

These tax proposals would fatally wound and eliminate the independent, domestic oil and gas exploration company. This sector of the oil and gas industry is responsible for the majority of the oil and gas exploration activity in the continental United States. The tax reform proposals would have the following effects:

1) Detrimentally handicap the economy of the oil and gas producing states as well as the country at large by creating massive unemployment.
2) Severely curtailing domestic production activity in the United States, increasing our dependence on the politically unstable Middle East for imports. Thus, the national security and national economy would be at jeopardy.

I respectfully submit that you do not support these Treasury tax reform proposals.

Very truly yours,

Russell K. Hargrove
14828 E. 34th Street
Tulsa, OK 74134

Harringtons

734 SOUTH MAIN • TULSA, OKLAHOMA 74119 • (918) 582-0116

February 13, 1985

Mr. David Doane
Senior Counsel, U. S. Senate
Energy and Natural Resources
Committee
United States Senate
Washington, D. C. 20510

Dear Sir:

I am greatly opposed to the tax reforms you are trying to pass regarding the oil and gas industry. Both Houston and Tulsa will be tragically hurt by these measures. These cities have relied heavily on the oil and gas industry and are now being hurt immensely by this industry's recession. Ironically, it has been the oil and gas industry that has made these two cities as great as they are today. These cities are trying to heal themselves, but if your measures are passed it could mean doom to many.

Your empathy in this matter would be very much appreciated. Think of the homes that will no longer have jobs if these measures go forth.

Sincerely,

Mrs Lee Harrington

Mrs. Lee Harrington

GH/csd

Enclosure

Copy: Senator Don Nickles

Established 1920

Hawkins

HAWKINS OIL & GAS, INC
400 SOUTH BOSTON SUITE 800
TULSA, OKLAHOMA 74103
(918) 585-3121

James F. Hawkins, Jr.
President and
Chief Operating Officer

Official Committee File

February 12, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy & Natural
Resources Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Doane:

Enclosed is a copy of an address I made before Senator Boren last week while he was in Tulsa hearing testimony for the current tax legislation affecting the energy industry.

Please include this address in the written record of Senator Nickles Energy and Natural Resources Committee.

Thank you for your help in this matter.

Sincerely yours,

James F. Hawkins, Jr.

James F. Hawkins, Jr.

JFH:maw

Enc.

SENATE [illegible]TEE ON
ENERGY [illegible] RESOURCES
FEB [illegible]

COMMENTS TO
SENATOR DAVID L. BOREN

BY

JAMES F. HAWKINS, JR.
HAWKINS OIL & GAS, INC.

February 8, 1985
Kerr State Office Building
Tulsa, Oklahoma

My name is Jim Hawkins, I am Chairman of the Board of Hawkins Oil & Gas, Inc. of Tulsa, Oklahoma. My brother and I employ 48 people in the state of Oklahoma.

Our company sponsors SEC registered public drilling programs. We have been doing this successfully since 1979 and have raised over $50,000,000. We currently have a $10,000,000 offering in the market place.

According to a survey recently undertaken by Arthur Anderson for the National Petroleum Council, if Treasury's proposals were enacted in their present form, our sales would be cut in half, to $5,000,000. The statistical information that went into writing this report was supplied by the Independent Petroleum Association of America, the Mid-Continent Oil & Gas Association and the Texas Independent Producers and Royalty Owners Association. I trust their information. This was the same group that said there would be no "fly up" in the price of natural gas on 1/1/85 when government price controls on natural gas discovered after 1978 ended. They were right.

Except for the drilling response by independents, domestic production today would be about 1.1 million barrels per day below 1979 levels. Since 1974, independents have increased their share of successful well completions: from 68.5% to 85% for oil wells, and from 86% to 90.4% for gas wells. Independents' share of lower 48 production increased from 30.5% in 1979 to 39.5% in 1984.

Historically, independents have accounted for 90% of wildcat drilling and 85% of all domestic drilling. Independents find more than 80% of the significant new discoveries which account for 56% of all new domestic reserves found. In short, the independent oil companies are the ones that develop the "lower 48" on shore reserves.

I won't go on about the jobs we create for third party industries, i.e., steel, drilling etc...you can get those statistics from IPAA when you get back to Washington D.C.

I am here today because I am extremely concerned about three issues the Treasury has raised in its report to the president - intangible drilling costs, depletion, and limiting the size of limited partnerships. But what equally concerns me is the information I am receiving from the member's of the Oklahoma Independent Petroleum Association who, on three occasions in the last two months, have visited Washington and held discussions with Secretary Regan and Baker, and Pearlman, McLure and McNamar of the Treasury Department. Their comments worry me. Sure, they say, some big energy banks would fail, the 600-700,000 jobs lost would "soon be absorbed in the new system"; or "We would like to see more on the energy security argument, but so far we're unimpressed; or "the oil business is just a business. There's nothing special about it." How about this one, "the tax system regarding oil and gas is wasteful, causing over exploration of our natural resources." McNamar suggests the plan would "only lower the price 1 to 2 more dollars per barrel" and that the "time to get in the energy business will be in 1992 when the price starts going back up." Finally the Oklahoma delegation was ushered out the door and advised to quit "crying wolf." (See Exhibit A)

Senator, what we have here is a very serious failure to communicate.

I agree, our industry is just a business. (See Exhibit B) It is also the most heavily taxed industry in the country. Let's review the last several years and see why investments in oil have been quote, "wasteful."

I, for one, didn't cry wolf or darken your door when the NGPA of 1978 was passed, or when the alternative minimum tax act of 1981 or the Windfall Profits Tax of 1980 were enacted, or when the states began raising their gross production taxes, or when crude oil was decontrolled, or when natural gas was decontrolled, or when the maximum tax was lowered from 70% - 50%, or when the price of crude dropped 30%, or when the price of gas went up to $10/MCF, thanks to the Federal governments 26 prices, then down to $2.75, or when many in our industry whimpered and declared bankruptcy. I did not "cry wolf" - I did not demand price supports. The system we have regarding oil and gas works - oil companies are still allowed to go broke - that's the acid test isn't it? That's free enterprise at work.

All that legislation just mentioned severally impacted our industry between 1977 to 1984. During that time I never once "cried wolf".

I can see how the Treasury can say the domestic industry is just throwing money away. Few business' could have survived both the onslaught of government legislation and taxes that this industry has put up with...plus have their product decontrolled - all in the last 3 years.

If you are not aware of what happens to an industry when it gets decontrolled, ask your friends in the airline, trucking, banking and railroad industries. It's nothing new and it's awesome. Profits are squeezed because the price of the product goes down due to more competition. The result is the price of their stock goes down and capital becomes harder to attract. The smaller less efficient companies get merged into the larger companies.

The "urge to merge" by the big oil companies is the end result of decontrolled oil and gas prices. But what happens after the merger. Exploration budgets are cut so expensive debt can be reduced. No new domestic oil and gas reserves are discovered - they're only merged. Our national energy security is weakened. Capital flees the independent operators, notes are called, both banks and operators go broke and are merged. The tax legislation has remained.

Our company's track record (See Exhibit C) shows our limited partner investors are receiving an average of a 19% return on their investment since 1976. I think this proves that the independent oil companies that don't make the news in the form of scandals, law suits and bankruptcy...are, in fact, efficient and producing. We are producing for our partners. We have to maintain this kind of return in order to compete with the other investments our limited partners can make...i.e., stocks, bonds, C.D.'s and Treasury bills. We are competing for investment dollars. High interest rates hurt us in our ability to reduce debt and attract capital.

Assuming we can raise $10,000,000 given today's price and tax uncertainties, (See Exhibit D) what do the numbers look like. We will assume that for that $10,000,000 of IDC the investor will receive a 2:1 return on his money - or $2 back for $1 of investment. That equates to an approximate 14% rate of return on his investment. To do that we must discover 666,000 barrels of oil or gas equivalent. The initial cost to the Federal government in taxes not collected that year amounts to $4.6 million. But assuming that 666,000 barrels of oil is sold for an average price of $30 per barrel over the life of the wells, the income tax the Federal government would eventually receive from the individual limited partners would amount to $6.5 million - or a net tax income increase to the Federal government of $1.9 million. The 7% gross production tax to the state of Oklahoma would be in excess of $1.4. Plus our company stays in business, pays taxes, and employs people who also consume and pay taxes. But look at our finding costs - $15 per barrel. How do we explain to our investors, who can "buy it on Wall Street" thru mergers for $6 to $8 per barrel, that this is a good investment. Because if that investor is in the 50% tax bracket and intangible drilling cost are still deductible, his actual finding cost per barrel is $8. Major oil companies don't have IDC or depletion - they don't look for the smaller reserves onshore because the reserves are too small and the finding costs are to high. Get rid of IDC for the independents and there won't be much onshore domestic exploration. In our little scenario, our one company reduces this nations import bill by $20 million. Our national security was improved because we are a little less dependent on foreign sources of energy and our balance of payments is reduced. Last year, $60 billion of our $120 billion balance of payments deficit was due to energy imports. This nation has 4.1% of the worlds known oil reserves (See Exhibit E) yet we consume 26% of the worlds oil each year.

Exhibit F shows that our natural gas "bubble" and total domestic reserves are quickly being depleted (as in depletion allowance) and not being replenished. Oklahoma is the 3rd largest producer of natural gas in the U.S. This trend has been reversed as early as 1981.

Senator, allow us to raise our much needed drilling dollars. Quit changing the tax laws as they relate to oil and gas and we will make you and this state proud of our industry once again.

The tax laws of this country have put more Americans in private dwellings than any other country - thanks to the mortgage interest deductibility "loophole." Through intangible drilling, depletion allowance and large limited partnerships this nation is the second largest producer of oil in the world today. Let's keep it that way.

Thank you.

EXHIBIT A

WATCHING WASHINGTON

with Patrick Crow

Battling Treasury

Despite the havoc the Treasury Department's tax simplification proposal would cause in the oil industry, Treasury Sec. Donald Regan has assured Oklahoma oil men the government doesn't want to put them out of business.

Regan also asked eight members of the Oklahoma Independent Petroleum Association to give him more data on how the plan would cripple drilling.

The eight were part of a 50 person OIPA delegation that lobbied against the tax proposal in Washington last week. The phalanx was a cross section of the industry—small producers, drilling contractors, service and supply, bankers, and accountants.

They were attempting to persuade the administration to drop several antioil provisions—which would end percentage depletion, expensing of intangible drilling costs, and deduction of dry hole costs before a property is abandoned—before President Reagan commits himself to the plan in his Feb. 6 State of the Union address. The detailed proposal will be sent to Congress about Mar. 1.

Although Regan was conciliatory, his top aides were not. Deputy Sec. Tim McNamar and Charles McLure, deputy assistant for tax policy, welcomed factual submissions but were not moved by the Oklahomans' oral pleas.

McLure, chief architect of the proposal, referred to one argument as "crying wolf." McNamar suggested the plan would have no more effect than a $1-2/bbl drop in oil prices.

Both stressed that the goal is to allow the free market, not the tax system, to determine where investments flow.

The oil men argued that U.S. production would be slashed. Oil imports and vulnerability to cutoffs would grow.

McNamar replied "We would like to see more on the energy security argument, but so far we're unimpressed."

He added that Treasury considers the simplification plan the world's largest rebuttable proposal. "It stands, unless somebody can come forward and disprove parts of it."

The Oklahomans tried. Tom Allen, chairman of the National Association of Royalty Owners, Ada, said his group estimates the proposal would cost royalty owners $112 million/year as one out of every 12 stripper wells are abandoned. Some royalty owners' taxes would rise as much as 204%.

Sam Hammons, an Oklahoma City attorney, presented the Interstate Oil Compact Commission's study showing the plan's effect on stripper wells (OGJ, Jan. 14, p. 41).

Energy Sec. Don Hodel assured the Oklahomans the President will place a higher priority on national security and energy independence than Treasury did.

Hodel added, "I have not seen the oil and gas industry this united on anything in the 2½ years I have been working with it. I encourage you to keep this up. I think the outcome will be satisfactory to you."

But overcoming Treasury's misconceptions about the oil industry promises to be an uphill struggle. That was apparent when McNamar said, "The oil business is just a business. There's nothing special about it."

New Mexico projects lost revenue of $14 million.

The 5¢/gal federal tax break was expected to cost the Federal Highway Trust Fund $200 million last year. •

OIL & GAS JOURNAL

WEEK OF JANUARY 21, 1985

A PennWell Publication

past state deficits.

The funds are to be repaid beginning next year. But some legislators propose that the funds instead be used to fund higher education.

Industry sources say failure to repay the funds might lead to pressures for higher severance tax rates. •

WHAT WE HAVE HERE IS A VERY SERIOUS FAILURE TO COMMUNICATE!

EXHIBIT B

SUMMARY OF GOVERNMENT ACTS SINCE 1977

1. Natural Gas Policy Act - 1978

   - Set-up 27 categories of natural gas
   - Deregulation on January 1, 1985
   - Gas contract abrogation and renegotiation
   - Fuel Use Act

2. Crude Oil Windfall Profits Tax Act of 1980

   - Set-up three crude oil categories
   - Numerous reporting requirements
   - Stripper oil and other exemptions

3. Revenue Act of 1978
4. Economic Recovery Act of 1981
5. Tax Equity of Fiscal Responsibility Act of 1982
6. Deficit Reduction Act of 1984

IF YOU WANT TO SIMPLIFY THE TAX CODE, QUIT CHANGING IT EVERY YEAR!

Exhibit C

HAWKINS INVESTORS NET CASH TABLE

December 15, 1984

Program	Limited Partners Contributions $000's	Cumulative Distributions $000's	% Payout
1976	$ 575	$3,144	547
1977	690	1,568	227
1978	945	1,162	123
1979	4,025	2,427	60
1980-A	5,603	1,253	22
1980-B	4,200	799	19
1981	8,740	962	11
1982	9,981	2,903	29
1983	10,000	500	5
1984	10,455	-	-

PROJECTED 1985 CASH DISTRIBUTIONS

TO INVESTOR WHO INVESTED $10,000 PER YEAR

Program	Initial Investment	Voluntary Assessment	Total Investment	Actual Distributions in 1984	Projected Distributions in 1985
1976	$10,000	$ -	$10,000	$ 7,700	$ 7,000
1977	10,000	-	10,000	2,900	2,400
1978	10,000	-	10,000	3,200	2,500
1979	10,000	1,500	11,500	950	2,000
1980-A	5,000	600	5,600	450	400
1980-B	5,000	-	5,000	200	200
1981	10,000	-	10,000	400	400
1982	10,000	2,300	12,300	2,330	2,460
1983	10,000	-	10,000	600	1,000
1984	10,000	-	10,000	-	500
Total	$90,000	$4,400	$94,400	$18,730	$18,860

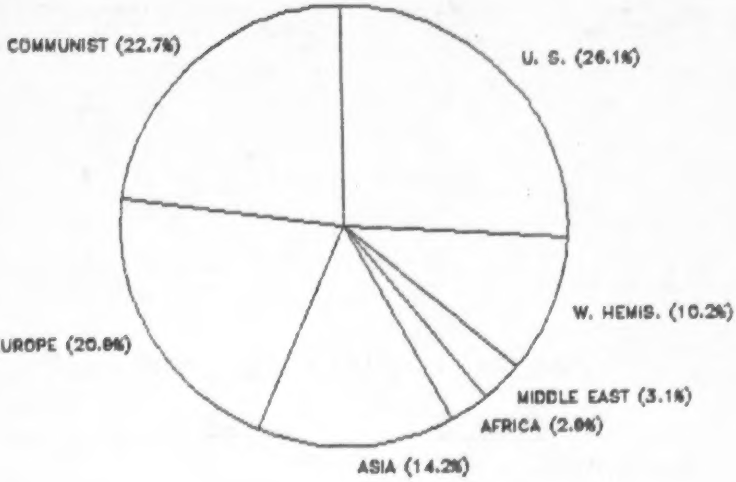
EXHIBIT D

ASSUMPTION:

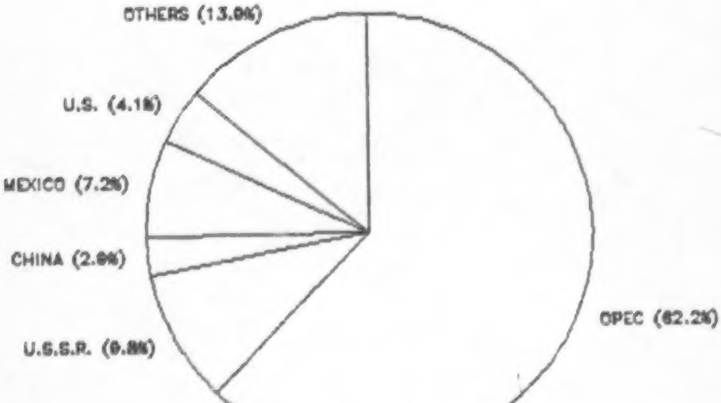
Size of Program	$10,000,000
Program Return	2:1
Deductible Amount To Limited Partners First Year	$ 9,200,000
Cost To Government In Tax Revenues First Year	4,600,000
Income To Government Over Life Of Program	$ 6,500,000
Net Income Tax Increase	$ 1,900,000
Equivalent Barrels Discovered	666,667
Gross Income Generated Assuming $30/BBL Over Life Of Program	$20,000,000
Finding Cost Per Barrel	$ 15
After Tax Finding Rate Assuming Limited Partners Are In The 50% Tax Bracket	$ 8
Income To Oklahoma State From 7% Gross Production Tax	$ 1,400,000

EXHIBIT E

WORLD OIL CONSUMPTION



WORLD OIL RESERVES



OPEC IS A FOUR LETTER WORD

Exhibit F

SPECULATION ON PERSISTENCE OF GAS "BUBBLE"

Year	Additions to Reserves Tcf	Production Tcf	Difference Tcf	Est. Effective Annual Deliverability Tcf	Est. Effective Surplus Deliverability Tcf
1982	17.3	17.5	- .2	19.0	1.5
1983	14.5	15.8	- 1.3	19.0	3.2
1984e	14.2	16.6	- 2.4	18.9	2.3
1985e	14.0	17.0	- 3.0	18.6	1.6
1986e	13.5	17.4	- 3.9	18.3	.9
1987e	13.0	17.5	- 4.5	17.9	.4
1988e	12.0	17.5	- 5.5	17.5	- .03
1989e	12.0	17.5	- 5.5	16.9	- .6

LONG-TERM SUPPLY-DEMAND BALANCE IN NATURAL GAS

Year	Discoveries Tcf	Production Tcf	Difference Tcf
1977	13.0	18.8	- 5.9
1978	19.4	18.8	.6
1979	12.2	19.3	- 7.0
1980	16.7	18.7	- 2.0
1981	21.4	18.7	2.7
1982	17.3	17.5	- .2
1983	14.5	15.8	- 1.3
1984e	14.2	16.6	- 2.4
1985e	14.0	17.0	- 3.0

HOEN EXPLORATION COMPANY, INC.

HXC

Sheila F. Hoen

February 13, 1985

Mr. David Doane
Senior Counsel
State Senate Energy and Natural
  Resources Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Doane,

I strongly object to the administration plan to revamp the federal income tax system and seriously view it as an attempt to destroy the prosperity of middle income America, and those who benefit from its largesse. By putting vast numbers of its citizens out of business and out of work, the government will in the long run reduce its tax intake.

In the oil and gas industry we are appalled at the administration view that the strategic importance of domestic oil and gas reserves is no longer a matter of concern. To me, this attitude appears to reflect a deep pessimism, an acceptance of the idea that we are faced with only one alternative, nuclear war. With any genuine attempts to negotiate nuclear arms reduction, surely it is more likely that 'limited wars' in the Middle East, the Far East, Africa or South America will be fought.

Since implementation of these tax proposals will eliminate the highly competitive independents in our industry, the U.S. will be left with a few major oil companies, who have their major reserves overseas in these "trouble spots." Thus our country will be vulnerable to any Khomeini or Quaddafi who wishes to bring the American economy to its knees.

Suite 220 • Nichols Hills Executive Center • 1000 West Wilshire Boulevard • Oklahoma City, Oklahoma 73116 • (405) 842-7417

There are large reserves of oil and gas in this country still to be found. In my opinion the U.S. economy will only make a smooth peaceful transition from oil and gas sources of supply to other energy sources of supply with a healthy domestic oil industry free from cutoffs, price manipulation, political blackmail and sabotage.

If this legislation is noted for, it means that our company and many thousands like it will be eliminated with no benefits accruing to the government at all. We are a small consulting company of geologists and landmen, yet still will pay over $110,000 in federal income taxes during the next four months.

Yours sincerely,

Sheila F Hoen

Sheila F. Hoen
Land Manager

SFH:lc

Robert G. Jackson
ENERGY CONSULTANT
ROUTE 3, BOX 171
McLOUD, OK 74851
405-964-5173

ALCOHOL FUELS • REMOTE GAS DEVELOPMENT • COAL CONVERSION

Some Considerations of the Effect of Recent Proposals for Tax Changes on the Economics and Future Prospects for the Oil Industry in Oklahoma

15th February 1985

SUMMARY

The conclusions of the Interstate Oil Compact Commission have greatly exaggerated the effects on the oil industry of proposals for tax reform made by the administration and various legislators.

These exaggerations are caused primarily because of the use of assumptions that have no evidence to support them and the mixing together of information on oil and gas production. This mixing is especially inappropriate since about two thirds of the energy produced in Oklahoma is in the form of natural gas, which is produced from about one third of the wells, and the price of gas and oil are sensitive to completely different market forces.

The forecasts of effects on the future drilling are doubly suspect because they do not differentiate between development drilling, which represents eighty per cent of the effort but has a four to one success ratio, and exploratory drilling which only has a three to seven success ratio. Nor does it make allowance for the fact that development drilling is made to maintain revenue from existing production which will benefit from reductions in the tax rate.

The analysis indicates that reductions in tax benefits will be detrimental to future operations. In fact it can be shown that reduced rates of tax are more important than tax benefits and that over a ten year period the treasury proposal and especially the Kemp and Kasten proposal are more beneficial to cumulative profit after tax than are existing tax regulations.

The projected loss of 90,000 jobs is purely statistical and represents more than the present direct work force. This projection is clearly unreasonable unless the changes in taxation will cause a severe cut-back in production from existing operations.

No analysis is made of the beneficial effects of these reduced rates of taxes on the 92 per cent of the population not employed by the independent oil industry either directly or indirectly.

The Reagan Administration and a number of Senators and Congressmen have proposed a simplification of the tax system including the elimination of the majority of the tax breaks presently allowed to a wide variety of special interest groups. They have all proposed that in addition either a single or a two stage level of taxes should be imposed starting at a higher level of income than with the present system.

Special interest groups cover a wide range including professional baseball clubs who have a cushion from the 15 per cent of seats paid for as tax deductible entertainment expenses by companies, property owners who buy second and third dwellings as tax shelters, and Independent Oil Companies who are granted tax breaks in the form of depletion allowances and exemption from windfall profit taxes denied to large oil companies.

Having been granted special dispensations for so many years these special interest groups are claiming that they should be allowed to carry on as before, irrespective of the virtue of the new proposals in providing for an equalisation of the tax load and a return of fairness in the application of tax allowances. Their claim to exemption is generally based on analyses which show that the removal of these breaks will wreak disaster on the Nation or the State or will cause unacceptable loss of jobs.

The statements made in January by the Interstate Oil Compact Commission are examples of an industry claiming a special dispensation from the application of the fairness so clearly required from the tax system. These statements fail to draw attention to the fact that over the last few years the independent oil industry has been the beneficiary of many million dollars of tax relief because of its exemption from the windfall profits tax and its ability to still claim depletion allowance. Nor does it mention that during the period when oil prices escalated so rapidly and while major oil companies were forced to sell their oil at low controlled prices from existing fields, stripper wells were allowed to sell at market price. As a result many low production stripper wells which had been shut in because of lack of profits were reopened and have generated considerable income for their owners during the last few years.

The analyses attempt to deduce from forecasts of revenues the effects of the elimination of depletion allowances, the effects of elimination of intangible drilling cost allowances and the effect of changes in methods of expensing enhanced oil recovery programmes. In doing this no attempt is made to differentiate between the incentives to develop increased production and those to explore for new reservoirs. Published information shows that slighty more than 80 per cent of all wells are drilled to develop existing fields and that almost 80 per cent of them become producers. On the other hand only about 30 per cent of exploratory drilling is successful. Because of this low level of risk the decision as to whether or not to drill development wells is based almost entirely on the price of oil or gas, either at the time the decision is made or estimated through the projected life of the field.

An examination of the data presented concerning the effect of present and proposed tax treatment of intangible drilling costs on capital expenditures shows that oil and gas production have been lumped together as barrels of oil equivalent with an assumed value of 19.63 dollars for 1984. It is unreasonable to do this since gas represents about two thirds of the energy produced in Oklahoma yet it is obtained from one third of the wells; the values of oil and gas are influenced by completely different market forces; the price of most pre-1977 gas sold interstate is controlled but the cost of similar gas sold intrastate depends on SB 137. It is also unreasonable to deduce possible effects on oil imports using gas quantities since almost all of the gas used in the United States is produced in the North American Continent. It is obvious that if the analysis had been made separately for the oil and gas industries the conclusions would have been quite different.

The results of such a comparison are presented in the attached tables and were made using figures from the analyses for crude oil production and price, and figures obtained from the Oklahoma Corporation Commission for natural gas. No attempt has been made to differentiate between the expenditure needed to drill for oil and gas in deriving the first two tables, since this was not done in the Independent Oil Compact Commission analysis. In order to make a better assessment of the different incentives to drill for oil and gas it has been assumed that the ratio of oil and gas dry holes is the same as that for producers. On this basis the investment by industry in drilling has been divided into portions for oil and gas. This information and comparisons with the revenue generated by each sector of the industry is presented in the third table for the period 1980 to 1984. All three tables relate only to Oklahoma but there is no reason to suppose that a similar analysis for Texas or for the Nation as a whole would produce any different results.

The figures show that although the revenue generated varies considerably, the proportion of revenue invested in new wells during the period from 1980 to 1984 remains fairly constant. The percentage investment for gas is much lower that that for oil and tends to fall as revenue increases. This is presumably caused by uncertainty due to the fact that old gas was controlled at a low price but new gas was subject to market forces. The figures also show that although the depletion allowance fell from 22 per cent to 15 per cent during that period, expenditure actually increased. A further examination of the same data shows that outside investment over the period varied widely and completely at random. It is therefore quite inappropriate to assume that the proposed tax changes will have any effect on drilling activity either from within the industry or from outside it when the evidence presented shows that there is no historical correlation between investment and either energy values or tax allowances.

It is also wrong to evaluate the effects of changes in tax rate by calculating implied tax benefits since tax benefits only exist when taxable income exists. When taxable income exceeds tax benefits then tax rate will become the most important influence on net profit after tax. Thus if a proper assessment is to be made of the various proposals for tax changes they must be done by comparing income after tax and not theoretical tax benefits.

The Independent Oil Compact Commission analysis of the effect of the proposed changes in the tax treatment of intangible drilling costs proposes that a national reduction of 33,920 wells drilled will lead to a loss in daily production of 838,293 boe or 25 boe/day per well. For Oklahoma the proposed figures are 4,147 wells and 123,450 boe/day, equivalent to 30 boe/day per well. On the basis of the averaged value for oil and gas of 19.63 $/boe used in the analysis these figures correspond to a value of 180,000 $/day and 215,000 $/day respectively. If allowance is made for royalty payments, severance tax and operating cost the revenue from each well before tax will reduce to 85,000 $/day and 100,000 $/day for the two cases.

Using these figures the effect of the tax changes have been calculated for a single well in Oklahoma comparing the current law with the proposals of the treasury and the proposals of Kemp and Kasten.

In all cases no taxes are due in the first few years of operation, partly because of the annual deductions and partly because of tax loss carryover. Once taxes become due however the impact of the lower tax rate soon becomes obvious and an evaluation over ten years for the three proposals shows that the total earnings, after allowance has been made for the original investment are highest for the Kemp and Kasten proposal, next highest for the treasury proposal and worst for the existing system. If the annual net incomes are discounted using mid-year factors for a 12% return then none of the schemes allows the value of the original investment to be recovered until after the tenth year of operation. The calculations are presented in the fourth table. In appraising them the reader should be careful to realise that the presentation is purely theoretical and that in an actual operation the tax benefits would be used to offset taxes on production arising from investments made in earlier years. Such more practical arrangements, however, will not change the general position that the proposal with the lowest tax rate and a reasonable position on capital depreciation will be the best proposal for realising the maximum income after taxes.

The analysis also claims that about 90,000 jobs per year will be lost in Oklahoma. This figure seems very high since the total employed directly by the oil and gas extraction industry in Oklahoma in 1984 was only 72,200 both to service the existing operations and to seek out new energy sources and probably no more than 10,000 were engaged by drilling companies and by drilling operations. Using the quoted direct to indirect ratio of 32 to 18 a further 40,600 indirect jobs may have existed. The employees of major oil companies in Oklahoma, such as Conoco, Phillips and Kerr McGee, are of no concern to this analysis.

It is clear that the number is high because it is based solely on a statistical relationship between dollars and employment rather than on facts. The use of such a method surely demands that the analysis takes into account the jobs which might simultaneously be created when a similar amount of money increases the average income of the large majority of taxpayers. There is no justification, therefore, for the analyses to claim that any jobs will be lost until it has shown that the proposed changes to the tax system will create less jobs than any they eliminate.

No consideration was given to drawing conclusions concerning the global impact of some of the effects predicted. For instance one might expect a small beneficial effect on world trade balances because of the reduction in U.S. oil production predicted to occur by the study. A small increase in U.S. imports could turn the surplus of oil on the international spot market into a slight shortage. This would in turn lead to a halt in the downward price of oil and maybe to a slight increase. In that case the small independent producer could expect that the income from his existing production would halt its downward trend. This in itself could provide him with sufficient incentive to continue to operate low production stripper wells without taxpayer subsidy or to invest in development drilling to increase production from his property.

At the moment the dollar is considerably overvalued relative to other world currencies, a fact which is having a rather disastrous effect on the ability of the American farmer to export his products. Not a small part of this high value is due to the fact that the world price of oil is established in dollars so that while the U.S. pays less and less for each barrel of oil it imports, other countries are paying higher prices in their local currencies as they become more devalued against the dollar. As a result an increase in U.S. imports could cause a downward trend in the value of the dollar with resulting benefits to American farmers, many of whom live in Oklahoma and Texas.

Any evaluation of a change should present both sides of the picture. The analysis presented by the Interstate Oil Compact Commission fails to do this. In fact that analysis not only fails to present the beneficial effects of the tax changes on the 92 per cent of the population of Oklahoma who do not work either directly or indirectly in the oil and gas extraction industry, but also fails to mention either the amount of tax relief that has been received in the past or the amount that will be received by existing producers if the tax rate on net revenue is reduced from 50% to 35% or less.

This note draws attention to only a few of the inadequacies of the claims that the removal of special tax benefits as applied to the independent oil companies would be disastrous for the U.S. and Oklahoma economies. In any circumstances the old adage will always remain true "if there is money to be made there will be somebody there to make it". Nevertheless the time has come to introduce an amendment preventing the entrepeneur from becoming rich primarily on the back of the average taxpayer. This is quite clearly not the aim of those who oppose the tax equalisation schemes presently being proposed in Washington.

Relationship between production and revenue for Oil and Gas in Oklahoma

Year	Oil Prod. MBPD	Oil price $ per bll.	Oil Rev. MMM $	Gas Prod. MMMMCFD	Gas Price $ per MCF	Gas Rev. MMM $	Total Rev. MMM $
1980	388.751	27.55	3.909	5.2114	1.49	2.834	6.743
1981	389.584	35.26	5.014	5.5623	1.87	3.797	8.811
1982	406.225	32.81	4.865	5.3287	2.73	5.310	10.175
1983	425.340	30.08	4.670	4.7658	2.80	4.871	9.541
1984	456.480	28.75	4.790	5.6365*	2.75*	5.658¯	10.448

Relationship between total revenue and internal and external investment for Oil and Gas in Oklahoma

Year	Total Rev. MMM $	Inside Inv. MMM $	% of Rev.	Outside Inv. MMM $	% of Rev.
1980	6.743	1.564	23.19	1.354	20.08
1981	8.811	2.058	23.36	3.186	36.16
1982	10.175	2.360	23.19	5.199	51.10
1983	9.541	2.167	22.71	1.530	16.04
1984	10.448	2.294	21.96	1.403	13.43

Relationship between revenue and internal investment for Oil and for Gas in Oklahoma

Year	Oil Rev. MMM $	Oil Inv. MMM $	% of Rev.	Gas Rev. MMM $	Gas Inv. MMM $	% of Rev.
1980	3.909	1.0635	27.21	2.834	.5005	17.66
1981	5.014	1.534	30.62	3.747	.6586	17.35
1982	4.865	1.6048	32.99	5.310	.7552	14.22
1983	4.670	1.4736	31.55	4.871	.6934	14.24
1984	4.790	1.5599	32.57	5.658	.7341	12.97

* Based on first ten months
¯ Prorated from first ten months

Effect of variable tax rates and depreciation schedules on net income

Treasury Proposal

Year	Inc.Bef. Tax	Tax Ded.	Taxable Income	Invest.	Tax	Net. Income	Mid-year 12% Disc.Fac.	Disc. Income
1	100,000	95,600	4,400	590,000	1,540	(491,540)	.945	(464,505)
2	100,000	126,300	(26,300)		0	100,000	.844	84,400
3	100,000	91,300	(17,600)		0	100,000	.753	75,300
4	100,000	79,600	2,800		980	99,020	.673	66,640
5	100,000	67,800	32,200		11,270	88,730	.601	53,327
6	100,000	51,600	48,400		16,940	83,060	.536	44,520
7	100,000	27,300	72,700		25,445	74,555	.479	35,712
8	100,000	16,100	85,900		30,065	69,935	.427	29,862
9	100,000	9,000	91,000		31,850	68,150	.382	26,033
10	100,000	25,400	74,600		26,110	73,890	.341	25,196
Total						265,800		(23,515)

Kemp and Kasten Proposal

1	100,000	135,500	(33,500)	590,000	0	(490,000)	.945	(463,050)
2	100,000	201,800	(135,000)		0	100,000	.844	84,400
3	100,000	195,900	(231,200)		0	100,000	.753	75,300
4	100,000	29,400	(160,600)		0	100,000	.673	67,300
5	100,000	29,400	(90,000)		0	100,000	.601	60,100
6	100,000		10,000		2,500	97,500	.536	52,600
7	100,000		100,000		25,000	75,000	.479	35,925
8	100,000		100,000		25,000	75,000	.427	32,025
9	100,000		100,000		25,000	75,000	.382	28.650
10	100,000		100,000		25,000	75,000	.341	25,575
Total						307,500		(1,515)

Present System

1	100,000	428,800	(328,800)	590,000	0	(490,000)	.945	(463,050)
2	100,000	42,500	(271,300)		0	100,000	.844	84,400
3	100,000	37,700	(209,000)		0	100,000	.753	75,300
4	100,000	36,700	(145,700)		0	100,000	.673	67,300
5	100,000	35,700	(81,400)		0	100,000	.601	60,100
6	100,000	4,400	13,900		6,950	93,050	.536	49,875
7	100,000	2,200	97,800		48,900	51,100	.479	24,477
8	100,000	1,100	98,900		49,950	50,550	.427	21,585
9	100,000	400	99,600		49,800	50,200	.382	19,176
10	100,000	200	99,800		49,900	50,100	.341	17,084
Total						205,000		(43,753)

PANHANDLE EASTERN PIPE LINE COMPANY
3444 BROADWAY
P.O. BOX 1348
KANSAS CITY, MISSOURI 64141

K. E. KALEN
PRESIDENT

February 22, 1985

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
FEB
WASHINGTON, D.C. 20510

Mr. David Doane, Sr. Counsel
U.S. Senate Energy and Natural
  Resources Committee
U.S. Senate
Washington, D.C. 20510

Re: Treasury Department's Tax Proposal

Dear Mr. Doane:

Enclosed herewith is a copy of my letter to Senator Don Nickles and a copy of the enclosures accompanying that letter. Will you please cause my letter and the enclosures to be made part of the record with regard to the Senate Energy and Natural Resources Committee's hearing on the Treasury Department's tax proposal.

Sincerely,

K. E. Kalen

K. E. Kalen

KEK:rls

Encls.

PANHANDLE EASTERN PIPE LINE COMPANY
3444 BROADWAY
P.O. BOX 1348
KANSAS CITY, MISSOURI 64141

K. E. KALEN
PRESIDENT

February 22, 1985

Senator Don Nickles
United States Senate
Washington, D.C. 20510

Re: Treasury Department's Tax Proposal

Dear Senator Nickles:

Thank you for your letter of February 5, 1985 in regard to the Treasury Department's proposed changes in oil and gas taxation. We are greatly concerned as to the effect of these changes upon our companies and certainly concur with the conclusion that the changes will seriously harm domestic oil and gas exploration, development and production.

Mr. R. L. O'Shields, Chariman of the Board of Panhandle Eastern Corporation, our parent company, has written letters to Mr. James A. Baker, III, then Chief of Staff and Assistant to the President, and to the Honorable Donald P. Hodel, then Secretary of the Department of Energy, which letters expressed the concerns of our companies. The letters describe the impact on the companies as to certain features of the proposals. The letters confirm what others in the industry have contended--that "the elimination of accelerated depreciation, investment tax credits, capital gains tax treatment and expensing of intangible drilling costs will have a severe impact on much of the industrial strength of our country."

Enclosed is a copy of each of the two letters.

I am, by a copy of this letter, also transmitting Mr. O'Shields' letters to Mr. David Doane, Sr. Counsel, Senate Energy and Natural Resources Committee, with a request that the letters be accepted as my comments in the record pertaining to the Treasury Department's tax proposals.

Very truly yours,

K E Kalen

K. E. Kalen

KEK:rls

Encls.

CC: Mr. David Doane w/encls.

PANHANDLE EASTERN CORPORATION
P. O. Box 1642, 77251, 3000 Bissonnet, Houston, Texas 77005

R. L. O'Shields
Chairman of the Board

December 19, 1984

Mr. James A. Baker III
Chief of Staff and Assistant
to the President
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20500

Dear Jim:

Re: Treasury Department Tax Proposal

We have completed an assessment of the Treasury Department's tax proposal which shows they would seriously and adversely impact our company's activities. Those impacts are set out in the attached copy of my letter to DOE Secretary Don Hodel in response to his recent request of members of the National Petroleum Council.

If in effect for 1985, these proposals would reduce the cash flow of our exploration and production subsidiary by $27 million. Had they been in effect for the year 1981, the cash flow for our total corporation would have been reduced by either $29 million or $48 million depending on whether or not windfall profit taxes were in force.

This substantial cash flow reduction would, as a consequence, have a number of undesirable effects on our company including: lower capital expenditures; reduced borrowing capacity; lower oil and gas reserves developed; reduced economic activity and lower employment levels. Other high risk, capital intensive businesses would in all likelihood be similarly impacted by the proposals.

While the general aims and several features of the proposals are desirable and laudatory, the negative features in our case, and I believe for many others, overwhelm the positive ones. It is ironical that this plan would destroy most, if not all, of the incentives for capital formation and capital investment which the Reagan administration worked so hard to put in place just three years ago.

The elimination of accelerated depreciation, investment tax credits, capital gains tax treatment and expensing of intangible drilling costs will have a severe impact on much of the industrial strength of our country. We urge that any tax reform plan proposed by President Reagan retain those sound features which are so vital to many important segments of our economy.

Sincerely,

R. L. O'Shields

Distribution of letter dated December 19, 1984 to:

Mr. James A. Baker III
Chief of Staff and Assistant
to the President
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20500

bcc: Panhandle Eastern Directors

TBIrwin
KEKalen
JTKennedy
GJKurk
CELasseter
AJLevin
SAWallace
HSWelch

PANHANDLE EASTERN CORPORATION
P. O. Box 1642, 77251, 3000 Bissonnet, Houston, Texas 77005

R. L. O'Shields
Chairman of the Board

December 18, 1984

The Honorable Donald P. Hodel
Secretary
Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20545

Re: Impact of Treasury Department Tax Proposals

Dear Mr. Secretary:

In response to your request to members of the National Petroleum Council to comment on the impact of the Treasury Department's recent proposals for tax simplification, we have determined that these proposals would adversely impact our company's activities, particularly our exploration and production operations.

Exploration and Production

We have conducted a detailed analysis of the effect of the Treasury's proposals on our wholly-owned subsidiary, Anadarko Production Company, which conducts our exploration and production activities. If the proposals were effective for 1985, Anadarko's federal taxes would be increased approximately $27 Million with a comparable decrease in cash flow. Anadarko's 1985 capital budget of $145 Million, which is based on cash flow, would of necessity have to be reduced by $27 Million, or 18.6%.

Virtually all of such a reduction would be in exploration and drilling activities, as these constitute the primary discretionary spending programs of an exploration and production company. The result would be a reduced rate of finding and developing domestic oil and gas reserves.

A further adverse impact could occur as a consequence of the reduction in the interest deduction (net of interest income) by a factor related to inflation. Based on 5% inflation in 1985, Anadarko's taxable income would be increased over $14 Million due to this feature of the proposal. This treatment would probably result in a further reduction in capital programs so debt could be reduced in order to mitigate such a penalty.

A summary of Anadarko's analysis is attached. Please note that if windfall profits tax were eliminated in 1985, Anadarko's tax increase would be reduced to $20 Million.

In addition to Anadarko, our company has other substantial business activities -- principally interstate natural gas transmission and contract drilling of oil and gas wells. In the brief time since your request, we have been unable to make an assessment of the impact of the tax proposals on our total corporate activities for the year 1985. We have, however, assessed the impact on total corporate results for the year 1981, which we believe provides a good indication of how these proposals would affect our corporation. The result of that assessment are as follows:

Impact of Treasury Tax Proposal on 1981 Cash Tax	1981 Return As Filed	Treasury Proposal Adjustments	1981 Return As Adjusted
Item			
Consolidated Taxable Income	50,574,161	146,735,319	197,309,480
Tax on Above	19,683,922	45,428,206	65,112,128
Foreign Tax Credit	-2,398,840	0	-2,398,840
Investment Tax Credit	-13,961,369	13,961,369	0
Research Credit	-299,334	0	-299,334
Minimum Tax	1,134,682	-1,134,682	0
Total Cash Income Tax	4,159,061	58,254,893	62,413,954
Windfall Profit Tax	28,870,003	-28,870,003	0
Total Cash Outlay	33,029,064	29,384,890	62,413,954

This shows that our 1981 taxes would have been $29 Million higher on the presumption windfall profit taxes were eliminated. With windfall profit taxes continuing, our total tax bill shown under "1981 Return As Adjusted" would be some $19 Million more than shown or a total bill of $81 Million as compared to $33 Million "As Filed."

While I have not enumerated all of the positive and negative factors of the Treasury proposal, suffice it to say that for our business and industry the negative factors such as capitalizing intangible drilling costs, eliminating accelerated depreciation, reduced interest deductions for inflation and loss of investment tax credit more than offset the laudatory features such as the 50% dividend deduction and reduced tax rates.

Some of the effects of such a substantial reduction in cash flow are: lower capital expenditures; reduced borrowing capacity; lower levels of oil and gas reserves developed; reduced economic activity and lower employment levels. None of these would serve the national interests and well-being, and would, I beleve, be contrary to the goals of the Reagan administration.

Sincerely,

R. L. O'Shields

attachment

Anadarko Production Company and Subsidiaries

Effect of Treasury Department Tax Proposals

1985 Forecast

($000s)

	Current Law	Treasury Department Proposals	
Taxable Income (Loss)	$(20,270)		$(20,270)
Capitalize IDC and recover it through depreciation.		$30,734	
Capitalize exploration and development overhead and recover through depletion.		21,145	
Reduce interest deduction (net of interest income) by a factor related to inflation. (Assumed 5% inflation rate.)		14,477 (1)	
Capitalize construction period interest.		5,500	
Deduct 50% of dividends paid.		(5,189) (1)	
Revise depreciation system for newly acquired assets.		1,436	
Repeal percentage depletion.		1,000 (1)	69,103
Taxable Income	(20,270)		48,833
Tax Rate	46%		33% (1)
Tax before Credits	(9,324)		16,115
Investment Tax Credit	(1,808) (1)		--
Net Tax	$(11,132)		$ 16,115
Additional Tax			$ 27,247

Proposals also provide for 33 month phase-out of windfall profit tax beginning January 1988.

1985 Forecasted Windfall Profit Tax	$11,000
Tax Rate	33%
Tax Increase if Repeal Were Effective for 1985	3,630
Net Savings	$ 7,370

(1) Permanent savings or loss of benefit.

Feb. 12. 1985

Official Committee File

Mr David Doane
Senior Counsel
United States Senate.
Washington D.C. 20510

Dear Mr Doane;

Hopefully enclosed copies of oil runs from Grace Petroleum Corp. and Koch oil Co. will help as to the several \$ taken off a barrel of oil. I share [1/2 × 1/8] with family members. Our share from Grace Petroroleum for two-year period was \$2,417.30

Please feel free to share this with colleagues.

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
FEB 19
WASHINGTON, D.C. 20510

Sincerely
Faye Kastner
1118 Evergreen Dr.
Pauls Valley, ok.
73075

GRACE PETROLEUM CORPORATION
6501 NORTH BROADWAY
OKLAHOMA CITY, OKLAHOMA 73116

DATE 12/11/84
PAGE 1

OWNER WINDFALL PROFITS TAX STATEMENT
FOR PRODUCTION DURING 10/84

NOTE TO OWNER - VOLUMES PER THIS STATEMENT DO NOT INCLUDE LOWER TIER PRODUCTION AS IT IS EXEMPT FROM THE WINDFALL PROFITS TAX.

OWNER NUMBER 48310 1

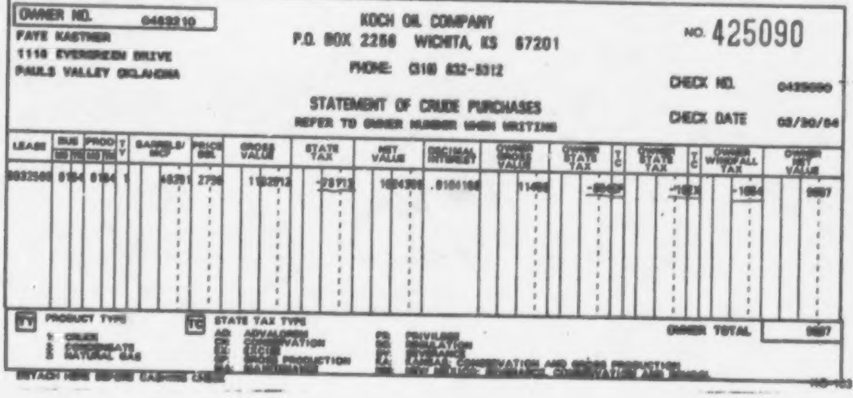
TIER CODES
B - UPPER TIER
C - DECONTROLLED UPPER TIER
G - STRIPPER
J - HEAVY CRUDE
K - NEWLY DISCOVERED
L - INCR. TERTIARY

KASTNER, FAYE
1118 EVERGREEN DR.

PAULS VALLEY OK 73075

*** KEEP THIS COPY - DUPLICATES WILL NOT BE FURNISHED ***

PROP. NO. PROD MO/YR	TIER CODE	TIER VOLUME WINDFALL PROFIT TAX	TAX RATE	GROSS WF PROFIT BASE PRICE	DEDUCTABLE SEV. TAX ADJ BASE PRICE	NET WF PROFIT
15806 01/83	G	385.08 2,072.62	60%	3,717.76 15.16	263.40 19.52	3,454.36
15806 01/84	G	442.39 1,733.33	60%	3,109.18 15.16	220.29 20.26	2,888.89
15806 02/83	G	348.66 1,603.90	60%	2,876.99 15.16	203.83 19.52	2,673.16
15806 02/84	G	427.66 1,676.70	60%	3,007.59 15.16	213.09 20.26	2,794.50
15806 03/83	G	367.07 1,577.59	60%	2,829.81 15.16	200.49 19.52	2,629.32
15806 03/84	G	457.60 1,783.46	60%	3,199.09 15.16	226.66 20.26	2,972.43
15806 04/83	G	378.10 1,575.73	60%	2,826.46 15.16	200.25 19.71	2,626.21
15806 04/84	G	430.47 1,621.84	60%	2,909.17 15.16	206.11 20.48	2,703.06
15806 05/83	G	410.45 1,706.92	60%	3,061.80 15.16	216.93 19.71	2,844.87
15806 05/84	G	424.35 2,055.24	60%	3,686.60 15.16	261.20 20.48	3,425.40
15806 06/83	G	405.67 1,686.22	60%	3,024.67 15.16	214.30 19.71	2,810.37



OWNER NO. 0483210
FAYE KASTNER
1118 EVERGREEN DRIVE
PAULS VALLEY OKLAHOMA

KOCH OIL COMPANY
P.O. BOX 2256 WICHITA, KS 67201
PHONE: (316) 832-5312

NO. 425090

CHECK NO. 0425090

STATEMENT OF CRUDE PURCHASES
REFER TO OWNER NUMBER WHEN WRITING

CHECK DATE 03/30/84

OWNER TOTAL [illegible]

PRODUCT TYPE
1 CRUDE
2 CONDENSATE
3 NATURAL GAS

STATE TAX TYPE
AD ADVALOREM
CN CONSERVATION
EX EXCISE
GP GROSS PRODUCTION
PR PRIVILEGE
RG REGULATION

DETACH HERE BEFORE CASHING CHECK

Official Committee File

Feb. 13, 1985
Rt. 2 Box 60 A
Newkirk, OK
74647

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
FEB 19
WASHINGTON, D.C. 20510

TO: Mr. David Doane
U.S.S.E. & N.R.C.

RE: Income Tax

Income tax needs simplification. However, not at the expense of the oil & gas industry in Oklahoma.

Intangible drilling costs and percentage depletion are vital facets of the oil & gas industry. Kay County, OK, has a fatal connection to oil & gas. If we lose the industry, life here as we know it will be fatal.

Much outside investment aids our economy. We need to retain intangible drilling costs & percentage depletion.

We need these for Oklahoma
We need these for a strong USA
We need these to keep Arab oil from dominating USA economy,

Sincerely

Don Klein
Farmer

LAMKIN BROS. OIL CO.
Oil Producers

JAMES E. LAMKIN
11725 S. 101st E. Ave.
Bixby, Oklahoma 74008

MARION E. LAMKIN
P. O. Box 117
Prue, Oklahoma 74060

Mr. David Doane Senior Counsel
United States Senate
Energy and Natural Resources Committee

February 12, 1985

Re: Federal Income Tax Simplification
Capitalization of Intangible Drilling Costs
Cost Depletion instead of Percentage Depletion

We are producers of "stripper" oil; which means we have low production but high capitalization and operational costs in comparison with income.

We favor capitalization of Intangible Drilling Costs. (IDC) We favor amortization of IDC over a 10 year period.

We favor Cost Depletion over Percentage Depletion.

Small oil and gas producers cannot take advantage of the present tax system due to their low income relative to their investment. Only majors and large independent oil companies and investors with very large incomes are greatly favored by the present tax system.

We are of the opinion that the proposed changes by the Treasury Department will not affect the decision to drill a good oil prospect. The price of oil and gas and the market demand have far more affect on the small producer's decisions.

Thank you,
Marion E. Lamkin.

SENATE COMMITTEE ON [illegible] RESOURCES
Official Committee File
FEB [illegible]

LYTM COMPANY, INCORPORATED

Ralph Spence, Jr.
President
310 3rd Street, 2nd Floor
P.O. Box 807
(406)265-3879
Havre, Montana 59501

February 13, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy and Natural Gas Resources Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Doane:

I am writing to submit comments for the record regarding proposed changes in the Federal income tax system. Specifically I am against the provision which would require the capitalization of intangible drilling costs and the replacement of percentage depletion with a form of cost depletion. As an independent producer of oil and gas, I feel these changes would seriously reduce exploration and sabotage our quest for energy independence.

From my perspective and experience, these tax incentives are essential to insure continuing exploration for new oil and gas reserves. The proposed changes would increase the after tax cost of exploration to a point which would discourage these high risk investments.

To maintain continuing additions to our petroleum reserves, we must have continuing exploration. The current over supply in oil and natural gas has already discouraged exploration by decreasing returns on investment. In the case of natural gas, our product cannot be sold until demand increases. This means there is no return on investment for about three to five years. Without existing tax incentives, these current market conditions would bring ongoing exploration to a standstill. To insure stable employment and a viable energy economy, these tax incentives must be maintained. Thank you for your consideration of these views.

Best regards,

Ralph Spence Jr

Ralph Spence, Jr.

RSJr/psc

Feb. 11, 1985

United States Senate Energy + Natural Resources Committee.
Mr. David Doane, Senior Counsel.

Dear Sir:

I see the Treasury Departments proposed changes in oil + gas taxation is a threat + discouragement to the Industry. Instead of helping the economy, the opposite would be the result.

The Largest percent of oil companies would cease efforts to discover + drill new wells. I can remember before 1973, the condition of the oil industry. This can happen again, Lets not the gas & oil Industry go down the proposed (changes) road.

It would also add to unemployment.

Sincerely,
Mrs. Corine Marcum
Route 1
Indiahoma, Okla. 73552

"Royalty Owner"

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
FEB 19
Committee File
WASHINGTON, DC 20510

ALLEN DOUGLAS MEESE
PETROLEUM CONSULTANT
FIRST NATIONAL CENTER, SUITE 1601
OKLAHOMA CITY, OKLAHOMA 73102
(405) 232-5433

February 14, 1985

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
MAR [illegible]
WASHINGTON, D.C. 20510

Mr. David Doane
Senior Counsel
United States Senate Energy and
Natural Resources Committee
United States Senate
Washington, D. C. 20510

Re: Comments Submitted for the Record

Dear Mr. Doane:

I am currently a petroleum consultant, and I have 21 years of oil business experience in engineering, in exploration and in management.

Please include the following comments in the records of the committee:

1. Domestic drilling is done largely by independents who need investor funding. This funding is heavily dependent on the tax incentives of intangible cost expensing and percentage depletion because these reduce the perceived risk and they enhance the effective cash flow in the early years of a project.

2. Investors invest in oil and gas largely because of tax incentives. They know they can expense intangibles against current income, reducing the risk of investing. The hope of profit is present, and the profitability of many projects is enhanced by the percentage depletion deduction, but even development prospects involve significant risk. The intangible expense is a risk free benefit whose size is known up front.

3. Our current energy surplus is like the situation of the monkeys whose home had a hole in the roof. As long as the sun shines why worry about the hole? As long as the citizen can buy plenty of gasoline, why worry about the dominance of import sources. Eventually overseas sources will dry up or be interrupted, and oil will be wanting. How about the U. S. balance of payments? I believe the balance of payments requires attention at least as much as does the deficit! Foreign oil is a major component of this deficit, and eliminating tax incentives will worsen this situation now and for the future as our import of oil continues.

4. The domestic oil and gas industry has been hit hard by the recent price decreases of both oil and gas. The good aspect of this slump includes the elimination of deep gas pricing (an ill advised market distortion) and the elimination of the "gold rush" oil people/companies seeking to exploit the rush of speculative money available under artificial pricing structures. The bad aspect of price decreases includes the wholesale bankruptcy of well founded companies who relied on some constancy of prices and policies. It includes the many hard working Americans who lost their jobs. The loss of these tax incentives will put more Americans out of work, more companies into bankruptcy and more people on the dole.

5. The Treasury Department proposal for tax reform is a poorly concealed tax increase. Congress and the President must unite to CUT spending. Oil and gas industry taxes have been increased heavily. We must meet our needs, eliminate many programs, cut most others by significant across the board percentages, and establish some long term bipartisan goals and policies. Is the country being well managed? I do not believe it is! I say NO! to tax reform as outlined, and YES to deep federal spending cuts.

Very truly yours,

Allen D. Meese

ADM:cpn

Official Committee File
[illegible] SOURCES
FEB 19 [illegible]
WASHINGTON, D.C. 20510

December 26, 1984

President Reagan
White House
1600 Pennsylvania Avenue
Washington, D.C. 20510

Dear President Reagan:

Many people in the State of Oklahoma are very upset at Treasury Secretary Regan's tax plan. It goes against the wonderful Republican platform and principles we all feel you believe in, along with the rest of us who love this country.

I hope you can find the time to study this in detail, because the Treasurer's purpose seems to be a "blueprint for radical restructuring of American industries and the economy" which WE DO NOT NEED.

Some of the more glaring defects are as follows:

First, no deduction for state and local taxes. We are overly taxed and a tax revolution could develop if no relief is in sight, especially with today's economic situation.

Second, for oil and minerals and intangible drilling cost deductions. By killing off the deduction for intangible drilling expenses, the major financial source of new oil discoveries will disappear. The oil industry has been crippled badly in the last couple of years and this industry is our only hope for counteracting dependence on foreign oil. All talk about the end of the oil monopoly will fade, as we would be catapulted into a new oil crisis. As a royalty owner of oil and gas, I resent as unfair and discriminatory, that the energy industry has once again been chosen as the key focus of a tax measure. This is contrary to your platform and the party I have long supported. The current proposal would severely reduce domestic exploration and create further bankruptcies among the smaller operators.

Repeal of percentage depletion for royalty interests would dry up capital currently propping up rural economies and many hard-hit farm and ranch operations.

Third, another dangerous treasury proposal is the reduction of charitable donations and deductions. This has never been tampered with before in the history of our nation and will deal a death blow to most charitable or Christian organizations and should be stopped in its tracks.

Fourth, the change in deduction of interest payments (as proposed) would deal a crippling blow to the investment real estate market. This industry has also been hurt badly in the last two years and needs a boost and not a low blow.

One of the basic things that is so unfair about these tax proposals is that they teach investors rules can and probably will be changed every year, so no one can plan for the future.

It looks as though the Grace Commission Report, which was a marvelous idea of yours, is not being used and implemented. Pressure should be brought to bear on Congress to utilize all of this report and see that they are aware of every single suggestion.

This is your golden opportunity to do the necessary surgery for our country. You are in a unique position to save America from destruction from within, because you are not seeking a third term. Let God be your guide in every one of these proposals and be not persuaded by those who think only of today and not the future of this country.

You may never see this letter, but I'm hoping that the person who opens it will give it special attention and convey the heart felt truth to you.

May God bless you.

Sincerely,

Dorothy Jeanne Millard

Dorothy Jeanne Millard
7321 Waverly Avenue
Oklahoma City, Okla 73120
405-842-6421

cc: Senator Don Nickles
Congressman Mickey Edwards
Treasury Secretary Don Regan

February 13, 1985

Official Committee File

Dear Mr Doane —

This is bad legislation. It will be especially harmful to oil producing states ~~especially~~ particularly Okla., whose tax base is heavily dependent on oil & gas production.

This does not contribute to energy self-sufficiency about which we seem to have forgotten but shouldn't have!

This will probably result in shut-in of a small stripper well on my property which contributes substantially to my retirement income.

Enactment will not soak the rich but prejudice ~~the~~ many medium income taxpayers and reduce tax revenue for the Fed Govt.

Thank you.
Austin Miles

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
FEB 19 [illegible]

AUSTIN E. MILES
[illegible] Lane
Midwest City, OK 73110

COMMENTS ON
TREASURY TAX PROPOSALS
OF NOVEMBER 1984
MOBIL CORPORATION

Mobil has serious concerns that the Treasury Department tax proposals contained in the Report to the President entitled "Tax Reform for Fairness, Simplicity, and Economic Growth" will have disastrous results for both the company and the country.

An analysis was made of the impact of these proposals on Mobil, using 1983 as a test, the latest year for which a federal income tax return has been filed. In 1983 Mobil invested $1.5 billion in domestic exploration and producing activities. A total of 102 million barrels of crude oil and natural gas liquids was produced and 51 million barrels of crude oil was added to the nation's reserves. Mobil also invested $250 million in that year to upgrade its United States refining and marketing operations.

If the Treasury Department tax proposals had been in the law in 1983, they would have increased the tax Mobil paid for that year by about $500 million. This would have represented a cash drain equal to more than 25% of the amount Mobil invested in its U.S. oil business in that year. Obviously such a damaging diminution in the company's financial resources and the economics of proposed projects would have forced a substantial reduction in its planned programs and activities.

This cash drain would have resulted principally from the proposals to eliminate (1) intangible drilling costs, (2) the investment tax credit, (3) ACRS, and (4) changes in the calculation of the foreign tax credit by changing the rules on sourcing of income and expenses and shifting the limitation from "overall" to "per country". The cash drain was determined after giving effect to the proposals to reduce the corporate tax rate, grant a dividends paid deduction and eliminate the windfall profits tax.

Projecting programs for domestic oil investment for the period 1986 - 1989 of about $2 billion a year, Mobil estimates that full application of all these Treasury Proposals would cost Mobil in net increased income tax and diminished cash flow an amount in the order of magnitude of $2 billion for the period, which figure equals about 25% of its planned domestic oil investment program.

In summary, the proposals would mean less investment by Mobil, which in turn will clearly affect our growth and ability to employ increased numbers of people. Multiplied by a similar effect throughout the oil industry, it is fair to say the proposals would force the industry into a long period of low growth, and result in increasing the reliance of our country on the political vagaries governing our importation of foreign oil. History clearly indicates the undesirability of such a course. It seems quite clear that these tax proposals are completely at odds with the Administration's energy policy of encouraging development of non-OPEC energy sources.

Exacerbating the situation is the fact that the recent radical drops in the price of crude oil, and the great risk of further substantial drops, find the domestic oil industry struggling at the present time to find the investment funds necessary to keep healthy its ratios of reserves to consumption.

In addition, not only would domestic operations be adversely affected, but foreign operations as well. The proposed tinkering with the foreign tax credit rules by shifting the limitation from "overall" to "per country" and the changes in rules on sourcing of expenses and income, would increase the tax burden on foreign operations and reduce already low margins. Many of our foreign competitors are state owned or subsidized producers or refineries and bear little or no foreign tax burden in the first place. All the rest pay only foreign taxes. Adding a further U.S. tax burden to the foreign tax burden already bourne by U.S. controlled companies will simply make competition against foreign owned competitors more difficult.

Therefore, adoption of long term tax and energy policies which would hamper the competitiveness of foreign oil operations while simultaneously discouraging domestic operations would seem particularly ill advised.

February, 1985

Samson Properties Incorporated

Samson Plaza
Two West Second Street
Tulsa, Oklahoma 74103
918 583-1791

Official Committee File

February 13, 1985

Dennis R. Neill
Senior Vice President

Honorable Don Nickles
United States Senate
Washington, D.C. 20510

RE: United States Treasury Department Tax Proposal

Dear Senator Nickles:

We have received your letter dated February 5, 1985, noting your plans to conduct a hearing for the United States Senate Energy and Natural Resources Committee in Oklahoma City February 15. As you are aware, the independent oil and gas sector would be adversely impacted by the Treasury proposal. The end result would be serious harm to the economy of energy producing states as well as a significant blow regarding any level of energy independence.

Pursuant to your invitation for written comments, you will find enclosed a copy of the remarks by Charles Schusterman, President of Samson Resources Company, given at a public hearing conducted by Senator Boren on Friday, February 8, in Tulsa. Also enclosed is a written paper prepared by Samson Properties on the issue of taxing as a corporation larger limited partnerships. I believe both of these documents provide important comments on the adverse impact the Treasury proposal would have on our industry. A copy of these documents is being sent to Mr. David Doane.

We certainly stand ready and willing to provide any data and information that would be helpful when considering the tax proposal, the domestic energy industry and our economic future.

Sincerely,

Dennis R. Neill
Senior Vice President

DRN:mn
Enclosures
cc: Charles Schusterman
Chuck Faber

✓ Mr. David Doane
Senior Counsel,
United States Senate Energy
and Natural Resources Committee
United States Senate
Washington, D.C. 20510

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
FEB 19
WASHINGTON, D.C. 20510

MISC3/dn52

THE LIMITED PARTNERSHIP
AND
CAPITAL FORMATION

Response to the Treasury Department Report
:o the President on "Tax Reform For Fairness,
Simplicity, and Economic Growth"

Presented at the Public Hearings
Conducted by the Honorable David L. Boren
Senator from Oklahoma
Tulsa, Oklahoma February 8, 1985

Prepared By:
Charles Schusterman
Samson Resources Company
Samson Plaza, Two West Second Street
Tulsa, Oklahoma 74103
(918) 583-1791
February 7, 1985

I am Charles Schusterman, Chief Executive Officer of Samson Resources Company, an independent oil and gas exploration and production company. We also buy producing oil and gas properties. Our corporate headquarters is in Tulsa and we have exploration offices in Denver, Houston and Tulsa. Samson and its affiliates manage or own interests in more than 2,600 wells located in 17 states. Approximately 650 of these wells are operated by Samson and its affiliates. These operated properties produce approximately 3,200 barrels of oil and 100 million cubic feet of gas per day. We employ approximately 350 people.

With the time allocated to me, I will discuss three proposed changes to the current tax system that will have an extremely adverse affect on our business. The first negative proposal is to tax limited partnerships with more than 35 limited partners as if they were a corporation. Dennis Neill, from our office, will address you in more detail on this issue after I have completed my remarks. The other two negative proposals would be the inability to expense intangible drilling costs (IDCs) and the elimination of statutory depletion for oil and gas production. Changing the current tax laws in these three areas would almost eliminate our effort to explore for oil and gas.

We fund our exploration effort from three sources. They are (1) limited partnership funds, (2) internal cash flow and (3) we sell a portion of our exploration prospects to other oil and gas companies, both to independents and major oil companies. If these three negative proposals are enacted, our sources of funding would be severly impacted. Also, the economic risk to continue to develop drillable oil and gas prospects would increase to such an extent that it would be my business judgment to radically decrease our exploration effort. We currently explore for oil and gas in the onshore areas of the United States.

For your additional information, our exploration effort did not begin until 1974 as a result of the Arab oil embargo when prices increased dramatically. These increased prices gave us the economic incentive to begin our exploration effort. All of our drilling is based upon an analysis of the economics of exploration. The triple negative affect of the three proposals would so adversely affect our economics that our drilling would be dramatically reduced.

I believe our limited partners would react so negatively that these funds would be completely eliminated from our exploration effort. Obviously, if larger limited partnerships like ours were legislated out of business, we would have no choice but to quit this segment of our business and reduce our exploration effort due to the loss of these funds. In our drilling programs from 1981 through 1983, our limited partners invested approximately $70 million with us for an average of over $23 million per year. Our largest year was 1983 when limited partners invested approximately $25 million with us. In 1984, our limited partners invested almost $19 million. This reduced investment in 1984 can in part be attributed to the current negative tax proposals. Also, the current reduced oil and gas prices have adversely affected our capital raising ability.

Actually, I believe that the inability to expense IDCs and loss of the statutory depletion allowance would not totally end drilling by independents. However, I do believe that investors into limited partnerships based upon emotion and economics would totally quit investing. This would have a severe impact on us and other independents.

As for our internal funds, these would still be available for exploration. However, I question the advisability of our continuing to invest in exploration. Although we have not specifically analyzed the economic affects of the lack of expensing of IDCs and the loss of statutory depletion, I believe that these two negatives would significantly reduce the economics of our exploration prospects. Certainly, some prospects would still justify drilling under the newly proposed negative tax changes, but how many? What percentage of our employment levels could we retain at the reduced level of activity?

It saddens me to think of how many geologists, land people, geophysicists, other explorationists and all the support personnel that would be adversely affected by these proposals. There has been a huge investment in time and money to create the talent pool to explore for oil and gas. Much of these skills would be wasted for the future. I hate to think of the emotional toll on so many people.

The third area of our funding comes from the sale of prospects to other independents and majors. Obviously, the independents would not have the funds to invest in our exploration prospects. The major oil companies could still buy our prospects. Their cash flow has increased immensely since 1973. The increased oil and gas prices on their company owned properties would allow them to continue exploring if they had enough quality economic prospects. Due to the size of our company, we are able to establish the creative environment for people so they can develop quality economic prospects. This innovative atmosphere that can be developed in a smaller company is important to finding oil and gas. But could we afford to retain our exploration team and become dependent on selling prospects to major oil companies? We don't believe that this would be a prudent way to conduct our business.

I believe that the retention of statutory depletion is extremely important. Obviously, we drill dry holes in our business and lose all our capital on those projects. We need statutory depletion on our successful projects to rebuild our capital base that was lost on dry holes. Without statutory depletion, it will be quite difficult for independents to prevent the ultimate loss of their capital. A business cannot survive unless it has the ability to retain its capital base. The unique investment characteristics of drilling for oil and gas with its dry holes must be recognized in the tax code. The independents need the statutory depletion allowance to rebuild their capital base lost by drilling those dry holes that we wish we had not drilled, but that is the characteristic of our business.

It concerns me deeply to destroy the independent section of the oil and gas industry. Its importance to the United States has been well documented by many others. Since most of the drilling in the United States is done by independents, their reduced drilling activity will cause us to become dependent sooner on foreign oil. This has serious economic and security implications for the United States.

During the 1970's, the independents lost much of their tax incentives and many tax incentives were reduced that had been part of the tax code for many years. However, prices for oil and gas had gone up enough during that period such that many independents could still obtain a fair economic rate of return with lessened tax incentives during that period. But times have changed now. The price of oil has declined from as high as $40 per barrel to as low as $25 per barrel now. These prices are now subject to a windfall profit tax that further reduces the actual price received. Gas prices on average are generally lower now than they have been in the past. Drilling activity is far below the level of 1981. Since the recent negative tax proposals have been made, drilling activity has started to decrease and is below the depressed levels of 1984. Many independent oil and gas companies are going bankrupt. The independent oil and gas company has no way to offset the adverse economic implication of the proposed changes in the tax laws.

I am for tax simplification and no tax increases. However, the proposed changes in the tax code is a pure tax increase on the independents when they are already under severe economic pressures.

If the government must raise taxes to the oil industry, I would suggest consideration be given to a crude oil import fee. This would also aid the conservation effort in the United States which is now decreasing because oil and gas prices are going down. Some tax credits would need to be enacted to protect some consumers who would be adversely affected by an oil import fee. Several distinguished people have called for a crude oil import fee. With decreasing oil prices, now is the time to seriously consider such a fee.

The tax code used to be simplier. If we had an oil import fee, which would be a tax increase for the oil industry, I would like to see the Treasury Department simplify the implementation of the provisions on statutory depletion and expensing of IDCs. Some revenues might be lost in simplifying this implementation of statutory depletion and expensing of IDCs but these revenues could be more than offset by a crude oil import fee.

In summary, I would estimate that our exploration effort would be reduced by approximately 80%. This is the wrong time to hit the independent oil and gas industry with such negative proposals. It would have an extremely adverse affect on our oil and gas reserves in the United States and would ultimately make us more dependent on insecure foreign oil.

I would like to thank Senator Boren and his staff for setting up this meeting and providing us an opportunity to submit information on these very important subjects. Senator Boren, your support in this effort is extremely important and again I would like to thank you for it. Now, I would like to introduce Dennis Neill, who will speak on the taxing of limited partnerships as if they were corporations.

THE LIMITED PARTNERSHIP
AND
CAPITAL FORMATION

A Response to the Treasury Department Report
to the President on "Tax Reform For Fairness,
Simplicity, and Economic Growth"

Presented at the Public Hearings
Conducted by the Honorable David L. Boren
Senator from Oklahoma
Tulsa, Oklahoma February 8, 1985

Prepared By:
Dennis R. Neill, Senior Vice President
Annabel M. Jones, Senior Attorney
Samson Properties Incorporated
Samson Plaza, Two West Second Street
Tulsa, Oklahoma 74103
(918) 583-1791
February 7, 1985

MISC3/dn47

INTRODUCTION

Summary

Included in the November, 1984, U. S. Treasury Department Report to the President entitled "Tax Reform for Fairness, Simplicity, and Economic Growth" is a provision which would treat a limited partnership as a corporation for tax purposes if at any time during the taxable year the partnership has more than thirty-five limited partners. Assuming that certain fundamental tax incentives remain in the Internal Revenue Code, the taxation of larger limited partnerships as corporations will remove an important source of external funding for certain critical United States industries.

The Treasury proposal on limited partnerships (the "Treasury Proposal") should not be adopted for the following reasons:

(1) The Treasury Proposal ignores inherent differences between a partnership and a corporation. The availability of different forms of business organization is a foundation of our business and economic commerce. Specific standards necessary to determine the classification of an unincorporated association as either a partnership or a corporation under the tax laws have been a continuous part of American tax law since 1935. At no time has the size of an organization (whether measured in terms of asset values or number of participants) been considered relevant for purposes of

determining the federal tax classification of an organization as a limited partnership.

(2) The limited partnership provides critical capital for several important industries in the United States, including oil and gas and real estate. Limited partnerships offered by registered broker/dealers have purchased approximately $200 billion of assets in the real estate and oil and gas industries since 1970. These partnerships are an important source of funds for critical activities in the United States - including multi-family housing and exploratory and development drilling. They provide investment opportunities for our citizens, with appropriate considerations of the risks inherent in each investment decision.

(3) With regard to oil and gas, limited partnerships provide a large portion of the external funds for the independent sector of the oil and gas industry. Recently, independents have accounted for approximately 30% to 35% of the exploration and production budgets expended in the domestic United States. While Wall Street, the banks and drilling funds have previously provided significant amounts of the external funds necessary for the independents' activities, in 1984 the partnership funds represented the only significant source of external funds.

(4) Legitimate concerns have been expressed about the "tax shelter" business. However, since 1969, six major tax reform

acts have, to a large extent, reduced the tax motivation for an investment, thereby refocusing attention on the underlying economics of the transaction. "Abusive" tax shelters that rely on write-offs well in excess of invested capital should be and have been a matter of concern and legislative redress. The larger partnerships, particularly those subject to registration under the federal securities laws, however, do not fit into the abusive category.

(5) Contrary to the discussions set forth in the Treasury Report, larger partnerships do not create the audit and administrative problems for the Internal Revenue Service. Indeed, the Treasury Proposal will lead to a proliferation of smaller partnerships subject to less regulation, thereby creating greater audit and administrative problems.

(6) A numerical limitation on the partnership structure under the tax laws is simply not logical in today's competitive business market. It is the marketplace that should dictate the size and capital to be efficiently raised within the partnership structure.

(7) The numerical limit of thirty-five limited partners contained in the Treasury Proposal would lead to a proliferation of the un-registered private placements - which are generally available only to the very wealthy. An element of wealth discrimination and basic economic unfairness would, therefore, be introduced into the Internal Revenue Code.

(8) Larger partnerships provide funds which create jobs, consume products, and generate state, local and federal taxes. The Treasury Proposal would destroy this source of external capital for many companies, and leave few options. Considering underlying policy issues which have recognized the need for tax incentives in certain capital-intensive and relatively high-risk industries, this cannot be a wise course of action.

General Discussion

In November of 1984, the Secretary of the United States Treasury Department, Donald Regan, delivered a report to the President entitled "Tax Reform for Fairness, Simplicity, and Economic Growth" (the "Treasury Report"). As has been well publicized, the Treasury Report sets forth a proposed framework for a fundamental change in the tax structure administered by the federal government. Numerous concerns have been expressed about the potential effect many of the proposals set forth in the Treasury Report may have on capital formation. As noted by Marshall R. Noecker, senior financial consultant of Arthur D. Little, Inc., a management consulting company, "[The Treasury proposal] hits hardest at the companies which are putting the most into the economy."[1]

You have heard and will hear a great deal of testimony and evidence concerning the Treasury's proposals' detrimental impact on capital formation in various industries. As an independent oil and gas energy company, Samson Resources Company is necessarily aware of the harmful impact the Treasury's proposals on expensing intangible drilling costs and removing the percentage depletion allowance will have on our industry. Tax reform packages put forward by other Congressmen incorporating elements of the "modified flat tax" concept will impact many capital-intensive industries. However, this paper will address another aspect of the Treasury proposals - that dealing with the recommendation that limited partnerships with more than 35 limited partners be taxed as corporations.[2]

A discussion of this issue is, of course, closely intertwined with the tax treatment afforded to the business engaged in by the partnership. This is because the partnership structure, from a tax perspective, permits the pass-through of taxable income or loss to the limited partners, with no taxes collected at the entity level. The tax effect of imposing corporate income taxation instead of partnership income taxation on a business is the sum of three items:

(a) the disallowance of the effective use of certain industry incentives provided in the Internal Revenue Code (the "Code");

(b) the additional layer of tax collected at the entity level; and

(c) the difference in the pattern of taxable income distribution (if any) from the entity to the investors -- dividend payouts may have a different pattern than partnership income allocations.

It should be noted that the Treasury's proposal on limited partnerships (the "Treasury Proposal") is not unique. In 1978, the Carter Administration first suggested limiting the size of limited partnerships. The House Ways and Means Committee conducted hearings to examine the issue and moved on a voice vote to withdraw the proposal from consideration. In September, 1983, the Senate Finance Committee published a staff report recommending reforms in corporate taxation. One of the recommendations in this staff report would have classified publicly traded limited partnerships as associations taxable as corporations.[3] In addition, Congressman Donald Pease at one time recommended that all partnerships with more than 100 members be taxed as corporations.

What has been lacking in the discussion by both the Treasury and the Senate Finance Committee staff is a detailed study of the importance under existing tax treatment of the limited partnership vehicle in general capital formation with regard to specific industries.

The balance of this presentation will focus on the limited partnership as a business organization from a historical perspective and conclude with a discussion of the limited partnership and capital formation.

THE PARTNERSHIP AS A BUSINESS ORGANIZATION

Historical Development

The partnership as a form of business organization has existed for over eight hundred years. Limited partnerships were first known in the Italian commercial centers of Pisa and Florence in the twelfth century as a means for individuals to invest their capital without being known or named.[4] The system next appears under the French civil law where general partnerships were derived through the law merchant from the continental societe's. Limited partnerships were also seen in the French civil law where they were derived from the commenda or societe' en commandite thereby permitting a person to invest and share in the profits of a partnership and yet limit his liability to the amount of capital invested.[5]

The partnership concept was brought to the United States by the French where it first appeared in their Florida and Louisiana settlements. The French influence is still seen in Louisiana where limited partnerships remain known as "partnerships in commendam." The use of the organization spread throughout the U.S. and, in 1822, New York became the first state to enact a limited partnership statute.[6]

In 1914 the Uniform State Law Commissioners adopted the Uniform Partnership Act (the "UPA"). The UPA has subsequently been substantively adopted by all 50 states and the District of Columbia. In recognition of the need to combine the advantages of a partnership format with limited liability for the majority of participants, the

Uniform State Law Commissioners adopted the Uniform Limited Partnership Act (the "ULPA") in 1916. In 1976 the Commissioners revised the ULPA and adopted the "Revised Uniform Limited Partnership Act (the "RULPA"). Either the ULPA or RULPA has been substantively adopted by 48 U.S. jurisdictions.

The unique characteristics of the partnership first seen in the twelfth century are still evident in the principles of partnership law currently used in the U.S. A partnership is generally considered an association of two or more persons to carry on as co-owners of a business for profit.[7] Under both the common law and the UPA, the partnership has generally, with a few exceptions, not been recognized as an entity separate and apart from its members.[8] In fact, early drafts of the UPA based on an entity theory were expressly rejected by the Uniform State Law Commissioners.[9]

Legal Characteristics of Partnerships

The inherent differences between a partnership and a corporation are numerous. As noted above, a partnership is an association of two or more persons organized to carry on a business for profit. Unlike a corporation, a partnership need not be formed with a written agreement. Although governed by the requirements of the UPA, a partnership is not required to comply with the myriad rules and regulations imposed upon corporations. In fact, the UPA specifically provides partnerships with the flexibility to tailor their activities to meet their unique needs.[10]

In exchange for this flexibility, certain duties and obligations are imposed upon individuals who choose to become partners. These duties include that of general liability for all partnership obligations and a general mutual agency relationship among all partners.[11] As mutual agents the act of every partner within the apparent scope of partnership business will bind the partnership unless the person with whom a partner is dealing has knowledge of the fact that the partner has no authority to do the particular act. Each partner is both a principal and agent of the other partners in transacting partnership business. Coincident with the general agency relationship in the conduct of partnership affairs is a fiduciary relationship among the partners.[12]

In contrast to general partnerships, a limited partnership is created according to certain statutory authorities (e.g. the ULPA or RULPA). However, both the ULPA and RULPA provide for much greater flexibility in creating the relationship between the partners than that provided by state corporation statutes. In addition to being a creature of statute, the distinctive element of a limited partnership, as opposed to a general partnership, is the ability, under most circumstances, to provide limited partners with limited liability for partnership obligations. The general partner in a limited partnership is generally liable for all partnership obligations. The agency relationship and fiduciary duties imposed upon partners in a general partnership is, however, identical to that created by a limited partnership. Although there are differences in the UPA and the ULPA/RULPA, in instances where the ULPA/RULPA is silent, the principles found in the UPA control.[13]

Except for the fact that both corporations and partnerships are organized as associations of two or more persons engaged in a business venture, the only real similarity between limited partnerships and corporations is that both are creatures of statute. Although it is intended that limited partners will only be liable for the amount of their contribution to the partnership, an individual investing as a limited partner assumes significantly greater risks of possible unlimited liability arising out of the partnership's business than a stockholder in a corporation. Under the ULPA and RULPA (and unlike a corporation's creditors), creditors generally have the right to seek a return of capital distributed to a limited partner in payment of partnership liabilities that arose before such distribution.[14] In addition, in the event that a limited partner exercises any kind of management responsibilities with respect to a partnership's business, he will become unlimitedly liable for the partnership's obligations.[15] A stockholder, on the other hand, may engage in all management responsibilities and not lose the limited liability status of his stock ownership.

Numerous other procedural differences exist between limited partnerships and corporations. The amount of credit available to a limited partnership is generally limited by the value of the partnership's and the general partner's resources as collateral. Partnership interests are ordinarily not pledgable for loans or credit. As noted above, unlike corporate shareholders, the limited partners in a limited partnership are mutual agents and fiduciaries for each other. Because of the special relationship between partners, the ULPA provides that limited partners, unlike corporate shareholders, are entitled to certain information from the partnership, including rights to an accounting and to inspect the partnership's books, without regard to a statutorily specified magnitude of ownership.[16] In addition, any voting rights available to a limited partner are limited and generally defined by agreement and not statute. Unlike corporations, a limited partnership has a limited life and will terminate upon the removal, death, bankruptcy or withdrawal of the general partner.[17]

Tax Treatment of Partnerships

Historically, the Code has consistently recognized the inherent and distinctive differences between partnerships and corporations and has treated only the latter as a distinct tax-paying entity. Such a distinction has thereby offered taxpayers a choice in selecting the form of organization to use (i.e. corporation, partnership or trust). The task of defining or classifying the various business entities into categories has been left to the judicial and executive branches of government. This approach was endorsed by the Supreme Court in the landmark case on partnership taxation, Morrissey vs. Commissioner, 296 U.S. 344 (1935), where the court noted that it is extremely difficult to translate the concept of an "association" taxable as a corporation into precise statutory language that would fix the status of every organization created.

The determination to treat partnerships and corporations differently under the tax laws has been a continuous part of U. S. tax law since 1909. The definition of a partnership utilized by the Internal Revenue Service (the "IRS") has remained substantively identical since its regulations were first enacted. The Code defines a partnership to include "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation." IRC§7701(a)(2).

The standards necessary to determine the classification of an unincorporated association as either a partnership or a corporation were first judicially recognized by the Supreme Court in Morrissey. The Court found that five criteria should be used in determination of whether an organization was required to be taxed as a "corporation": 1) capacity to hold title to property in the organization's name, 2) centralized management through representatives of the members, 3) security from termination or interruption by death of the owners of beneficial interest, 4) free transferability of interest, and 5) limitation of the members' personal liability.

The standards set forth in Morrissey have been used exclusively by the courts and the IRS since 1935. The IRS' regulations promulgated under the Code of 1939 briefly set forth the tests for distinguishing a partnership from a corporation by providing that, if an organization was not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of existence, and if its management was centralized in one or more persons in a representative capacity, the organization was to be treated as an association taxable as a corporation. Reg. 118, §§39.3797-2, 39.3797-4, 39.3797-5.

The provisions found in the Code of 1954 as originally adopted did not differ from the 1939 Code. In response to efforts by the IRS to treat professional associations formed by doctors and lawyers as partnerships, and not corporations, the IRS issued much more specific regulations in 1960 (the "Kintner Regulations") setting forth the distinctions between organizations entitled to partnership treatment under the Code and those subject to corporate tax treatment. Reg. §§301.7701-1 et. seq. (1960).

The Kintner Regulations continue to provide the guidelines with which to determine partnership status. The cornerstones of the Kintner Regulations are grounded in four "corporate" attributes, all of which are premised on the Supreme Court's holding in Morrissey. These four attributes are 1) continuity of life; 2) centralized management; 3) limited liability and 4) free transferability of interest. The Regulations provide that, if an organization possesses three of the four corporate characteristics, it will be taxed as a corporation.

Although the Kintner Regulations do not blindly follow the legal principles set forth for partnerships under the UPA or ULPA, they do recognize the requirements of the Uniform Acts. In fact, any partnership duly formed and operated under a ULPA statute will be taxed as a partnership under the Kintner Regulations.[18]

Since enactment of the Kintner Regulations the IRS has promulgated two important Revenue Procedures concerning classification of an organization as a partnership, Rev. Proc. 72-13, 1972-1 C.B. 735 and Rev. Proc. 74-17, 1974-1 C.B. 438. Both of these Revenue Procedures tighten the IRS' internal procedures concerning partnership ruling requests. Significantly, however, both Revenue Procedures are fully grounded on the principles first set forth in Morrissey and later adopted in the Kintner Regulations. No additional standards have been set forth. Recent judicial decisions in Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975), and Phillip G. Larson, 66 T.C. 159, [1976 Transfer Binder] CCH. Tax Ct. Rep. Dec. 33, 793 (1976), have continued to base their holdings concerning partnership status on the four corporate attributes noted above.

In early 1977 the IRS attempted to issue new regulations in proposed form that were intended to replace the Kintner Regulations in their entirety. Proposed Reg. §301.7701-1, -3, 42 1038. It is important to note that these proposed regulations retained the Morrissey corporate characteristics standards derived from the Supreme Court's opinion and utilized in the Kintner Regulations and did not set forth new criteria on which to rely. The proposed regulations eliminated the "preponderance" test of the existing regulations thereby providing that an organization could be treated as a corporation if it possessed as few as two corporate characteristics. In addition, the regulations substantially altered the tests for determining the existence of the four key corporate characteristics. Due to intense protests from real estate interests and the Department of Housing and Urban Development asserting that the proposed regulations would classify most partnerships as associations taxable as corporations and thereby remove tax incentives available to individuals investing in a partnership format and devastate real estate investment and housing starts, the Secretary of the Treasury withdrew the proposed Regulations two days following their publication.

The current tax classification system for partnerships and corporations has evolved over a long period of time and has been developed through litigation and administrative process. At all times the basic principles distinguishing partnerships from corporations have been considered and recognized. At no time has the size of an organization (whether measured in terms of asset values or number of participants) been considered relevant for purposes of determining the federal tax classification of an organization. The number of participants in a venture is not an intrinsic corporate trait and should not be considered when developing legal principles on which tax treatment is based.

THE LIMITED PARTNERSHIP AND CAPITAL FORMATION

The Importance of Limited Partnerships

As noted at the beginning of this discussion, the utility of the partnership is, to a large extent, dependent on the tax treatment of the partnership business. Tax benefits can only attract investment to a particular industry if the tax benefits are, in fact, available to the investor. How important is the partnership when specific tax incentives are available?

Certainly, the case of the partnership should not be overstated:

> Partnerships are rather complex business organizations and are the least used of all the business forms available. There are about one million partnerships in the United States, producing about $83 billion in annual sales.
>
> ....
>
> Corporations are legal, taxable entities that are separate from their stockholders. The corporate mode predominates in economic importance. There are about 1.5 million corporations in the United States, and their combined sales are about $1.5 trillion for average sales of $1 million per corporation per year.[19]

The number of partnerships which have been formed as law firms, accounting firms, service companies, and so forth represent the majority of the partnership organizations. By way of perspective, it has been estimated that in 1984 investment in publicly registered investment partnerships was $8.2 billion.[20]

Indeed, the amount of capital invested in publicly registered partnerships in 1984 was less than in 1983. Furthermore, by the Treasury's estimates, only 15,000 of the more than 1.5 million limited partnerships have more than 35 partners.[21] Therefore, it is arguable that the Treasury Report overstates the impact of the utilization of the partnership for tax purposes when it suggests, "The availability of pass-through tax treatment for limited partnerships, regardless of size, has encouraged a significant shift in investment capital from the corporate sector to the partnership sector...."[22]

On the other hand, the limited partnership provides critical capital to several important industries in the United States, including oil and gas and real estate. Approximately 35% of all funds invested in publicly registered limited partnerships in 1983 engaged in oil and gas exploration and production, while more than 50% of the funds invested in publicly registered partnerships were involved in real estate investment and development. Limited partnerships offered by registered broker/dealers have purchased approximately $200 billion of assets in the real estate and oil and gas industries since 1970.[23] These partnerships have been an important source of funds for critical activities in the United States - including multi-family housing and exploratory and development drilling. The remainder of this discussion will be restricted to oil and gas.

Funding Sources for Oil & Gas Exploration and Development

The United States domestic oil and gas industry is typically separated into two components when discussing exploration and production - the majors and the independents. While definitions vary, the majors can be considered the 25 to 30 largest oil and gas companies, all of which tend to be integrated in the industry and publicly held.

In 1980, the independents accounted for 32% of the $33.1 billion spent on exploration and production efforts in the United States.[24] This amount is estimated to decline to 29% of a much larger total budget in 1990 - primarily as a result of increased offshore drilling - that is principally an activity of the majors.[25]

Fund sources for the majors and independents are almost the reverse of each other. For the majors, approximately 21% of their funding needs are met by external sources, with the independents relying on external sources for 60% to 65% of their exploration and production funding needs.[26] For the majors there has been negligible reliance on limited partnerships to fund a portion of the external sources. For the independents, however, limited partnerships in 1980 provided 36% of external funding.[27] To a large extent, the limited partnership for the independent replaces commercial paper available to the majors for external funds.

How important are the independents when viewing the U.S. domestic energy scene? Independents drilled 84% of all exploratory oil and gas wells drilled in 1983 in the United States. A majority of these independents used the limited partnership form in some manner for such drilling.[28] Limited partnerships permit individual investors to balance the extraordinary risks of oil and gas exploration with the incentives designed to encourage such risk taking.

As another indicator, during the five-year period 1977-1981, total industry expenditures for drilling and completing U.S. on-shore wells amounted to $92.7 billion. Of this amount, $20.7 billion - or 22% of the total outlay - was represented by public or private drilling partnerships or joint ventures.[29] It has been estimated that about 25% of all on-shore domestic U.S. oil and gas wells are drilled with capital provided by individuals as limited partners.[30]

Recent events have added new uncertainties to the important activities undertaken by the independents. These include (i) volatile energy prices, (ii) high interest rates, and (iii) bank difficulties, resulting in higher lending policy requirements.

The tremendous difficulty facing the independents in seeking external funding sources can be noted from the following table:

External Funding Sources for Independents

	1981	1982	1983	*1984
		Billion$		
Wall Street and banks	10.4	7.0	0.0	-1.0**
Public, private drilling funds	9.9	2.5	1.5	1.0
Total	20.3	9.5	1.5	0.0
Industry drilling expenditures	36.7	29.0	19.0	22.5
External funds as percent of total expenditures	55.3	32.8	7.9	0.0

*Estimated
**Minus value results from accelerated recall of loans and scarcity of new loans.
Sources: Bureau of the Census, Smith Barney, Walker Energy

(As reported in Parker, Marcia A., "Independent Producers Tapping New Sources of Capital", Oil & Gas Journal, January 7, 1985, pg. 43.)

A grave new uncertainty has been created by the Treasury Proposal. There can be no doubt that capital formation has already been greatly impaired by the Treasury Proposal. The partnership issue, along with attacks on the tax incentives which are vital to this industry, have reduced and will continue to reduce important external sources of funds for our domestic energy exploration and production activities.

The Larger Partnership in a Regulated Environment

There has been a great deal of discussion and concern over what has been labeled the "tax shelter" business. Indeed, the ability to take deductions far in excess of the amounts invested in a project, where there is little or no taxable income generated, brings into question the fairness of the available benefit. It should be recognized, however, that beginning in 1969 Congress addressed itself to this issue. Since that time, six major tax reform acts[31] have, to a large extent, reduced the tax motivation for an investment thereby refocusing attention on the underlying economics of the transaction. "Abusive" tax shelters that rely on write-offs far in excess of invested capital should be and have been a matter of concern and legislative redress. The large, publicly registered limited partnerships do not fit into this category of "abusive". They are highly regulated under tax, securities and state regulations and statutes. Tax benefits in their present form remain critical, however, to capital-intensive industries in a global economy. The limited partnership is one important vehicle for utilizing such benefits and providing external funds to important U. S. industries.

This analysis calls for further development of several ironies created by the Treasury Proposal.

(1) The Treasury Report asserts that "A limited partnership with a large number of limited partners also presents serious audit and administrative problems for the Internal Revenue Service. An adjustment in income or loss of the partnership generates a corresponding adjustment for each of the parties".[32]

However, the opposite conclusion appears more logical. Larger partnerships are subject to much greater regulation and overview at all levels of government. The Treasury Department testified before the Senate Finance Committee that larger partnerships "[are] less likely to engage in abusive partnerships than partnerships with fewer partners."[33] At the request of the Treasury, the Tax Reform Act of 1984 contains a provision requiring larger partnerships or publicly registered partnerships to obtain a tax shelter number, thereby increasing the ease of monitoring filings.

It is interesting to note that a report prepared by the staff of the Joint Committee On Taxation dated February 17, 1984,[34] asserted that additional resources of the IRS as well as the Tax Court were being devoted to tax shelter cases. Testimony submitted to the staff, however, would indicate that these resources have not been utilized in connection with the larger limited partnerships:

> No abuse, fraud or evasion has been proved or alleged in court by the IRS during the fifteen year existence of the publicly registered limited partnership business....
>
> We have concluded that "abusive shelters" (by IRS definition), as opposed to heavily tax motivated transactions, account for about 10% of the private placement market for limited partnerships and none of the publicly registered market. Most abusive shelters are not involved in real estate or oil and gas activities as the previous statistics cited on IRS audit experience indicate. "Abusive shelters" are about 4% of the total market for limited partnerships, a number in line with published IRS estimates of revenue loss for this activity.[35]

(2) There is another important consideration when discussing a numerical limitation such as the 35 limited partner proposal. In today's very competitive environment, business efficiency is a requirement for survival and profitability. Is a partnership of 35 more efficient to operate than a partnership of 150? Is a partnership with investment capital of $5,000,000 more efficient than one with $2,000,000? These are questions that should be addressed in the marketplace.

Indeed, larger partnerships may be less expensive to form and operate on a per unit scale then the smaller partnership. Smaller partnerships may be able to seek unique opportunities on a faster track than larger partnerships. Businesses and their markets should deal with these questions of efficiency and size.

(3) The numerical limit of 35 limited partners contained in the Treasury Proposal would lead to a proliferation of the unregistered private placements - which are generally available only to the very wealthy. Public offerings, which often include programs offering little shelter but an opportunity to have an interest in an underlying asset, would become unavailable for the small investor, including Individual Retirement Accounts ("IRA"s). This is an element of wealth discrimination - making the Code less fair.

(4) The Treasury Department believes that revenue enhancement will be achieved by taxing larger partnerships as

corporations. One must consider what activity will not occur if the Treasury Proposal is adopted - at all levels of government. Furthermore, the limited partnership business should be considered in its whole:

> Very few public partnerships generate pass-through net losses. Loss pass-through in public partnerships is only for the first several years of operation and is primarily in oil and gas drilling (a subcomponent of all oil and gas), which accounted for only 7% of public partnership capital raised in 1984. Twelve and one-half billion of the $29.5 billion raised since 1979 is in "income" partnerships .... Income partnerships "pass through" income partially or wholly taxable.
>
> Due to the "income" component of the public investment partnership market and the maturation of public partnerships, the aggregate publicly registered investment partnership industry reports net taxable income. The $65 billion of publicly registered limited partnership assets outstanding probably produces net taxable income of $5 to $6 billion annually.[36]

CONCLUSION

On January 15, 1985, Senator Boren, along with six other Senators on the Senate Finance Committee, addressed a letter to Donald Regan noting concern about effective date provisions contained in the Treasury Report. As stated in that letter, "Businessmen, as well as their creditors and investors in all sectors affected by the proposal, are postponing important business decisions."[37]

This letter is an important communication and recognition of a problem. The greater problem is the attempt to legislate out of existence, as far as its practical application in many crucial industries, an important vehicle of capital formation in the United

States - the limited partnership with more than 35 limited partners. The funds provided by this vehicle supply resources for developers and exploration companies to start new projects and positively influence economic activity. Jobs are created, products are consumed, state, local and federal taxes are paid. The Treasury proposals would destroy this source of capital for many companies - and leave few options for external funds. That is not a wise course of action considering underlying policy. We are striving for some amount of energy independence and reasonable housing opportunities for our citizens. Appropriate incentives and external capital must be available - including the ability to utilize the limited partnership.

- NOTES -

1. "Tax Proposals Worry Business," The Tulsa Tribune, November 28, 1984, pg. 80.

2. "Tax Reform For Fairness, Simplicity, and Economic Growth," The Treasury Department Report to the President, November, 1984, Vol. 2, pp. 146 et. seq.

3. "The Reform and Simplification of the Income Taxation of Corporations," Committee on Finance, United States Senate, S. Prt. 98-95, September 22, 1983.

4. See Bromberg, Crane and Bromberg Law of Partnership, §26.

5. See Henn, Handbook of the Law of Corporations and other Business Enterprises, pg. 66.

6. 1822, N. Y. Laws, Ch. 244.

7. Uniform Partnership Act ("UPA") §6.

8. Henn, Ibid, pg. 48.

9. Henn, Ibid.

10. See UPA §§9 and 18.

11. UPA §9 and 15.

12. UPA §21.

13. Wertheimer, Linda A., "Substantive Law and Special Problems of General and Limited Partnerships," Partnerships: UPA, ULPA Securities, Taxation and Bankruptcy, Philadelphia:American Law Institute - American Bar Association, 1984, pg. 8.

14. See Uniform Limited Partnership ("ULPA") §§15, 16 and 17.

15. ULPA §7.

16. ULPA §10.

17. ULPA §20.

18. Haines, Bruce D. and Marcus H. Strock, "Federal Income Tax Classification of Limited Partnerships Formed Under the Revised Uniform Limited Partnership Act," St. Mary's Law Journal, 9:489,501 (1978).

19. Zabalaoui, Judith, "Choosing a Form of Business Organization," Financial Strategies & Concepts, Winter 1985, pg. 32.

20. Stanger, Robert A., "Stanger's Position Statement on The Treasury Proposal," The Stanger Report, February, 1985, pg. 6.

21. "Tax Reform For Fairness, Simplicity, and Economic Growth," Ibid., pg. 148.

22. Ibid., pg. 147.

23. Stanger, Ibid., pg. 5.

24. Carey, James H., "Funding the U. S. Petroleum Industry," Oil & Gas Journal, November 8, 1982, pg. 160.

25. Ibid.

26. Ibid., pg. 162.

27. Ibid.

28. West, Jim and Glenda Smith, "Independent Sector Slowly Recovering," Oil & Gas Journal, October 22, 1984, pg. 87-93.

29. "The Critical Role of Passive Investors in Domestic Exploration," Investor's Tax Shelter Report, Investment Search, Inc., July - August, 1982, pg. 5.

30. Stanger, Ibid., pp. 7-8.

31. Tax Reform Act of 1969, Revenue Act of 1971, Tax Reform Act of 1976, Economic Recovery Tax Act of 1981, Tax Equity and Fiscal Responsibility Act of 1982, Tax Reform Act of 1984.

32. "Tax Reform For Fairness, Simplicity, and Economic Growth," Ibid., pg. 147.

33. Testimony of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, Hearings on Reform and Simplification of Corporate Taxation, Senate Finance Committee, October 24, 1983.

34. "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions," Joint Committee on Taxation, JCS-5-84, February 17, 1984.

35. Letter (undated) from Robert A. Stanger, Robert A. Stanger & Co., to John J. Salmon, Chief Counsel, Committee on Ways and Means, relating to "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions," Joint Committee on Taxation, JCS-5-84, February 17, 1984.

36. Stanger, Ibid., pg. 6.

37. Letter, January 15, 1985, from Senator David L. Boren, et. al., to Donald T. Regan, Secretary of the Treasury, pg. 1.

AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS
Oklahoma Section

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The following statement is sent to be included as a written comment for the record of the United States Senate Energy and Natural Resources Committee field hearing held in Oklahoma City, Oklahoma on Friday, February 15, 1985.

Robert A. Northcutt

Robert A. Northcutt
President, Oklahoma Section
American Institute of Professional
Geologists (AIPG)

Statement
By
Robert A. Northcutt
To The
U.S. Senate Energy and Natural Resource Committee
February 15, 1985

Mr. Chairman, my name is Robert A. Northcutt. I am a Certified Professional Geologist engaged in independent practice as a Petroleum Geologist in Oklahoma City, Oklahoma, and appear in my elected capacity as President of the Oklahoma Section of the American Institute of Professional Geologists and as a member of the National Executive Committee of the American Institute of Professional Geologists.

The American Institute of Professional Geologists (AIPG) is a National Organization that certifies the competence and ethical conduct of geologists from all specialties. Within the 37 State Sections there are over 4,600 members from all branches of the science who are employed in industry, consulting, independent oil production, government and academia.

The Oklahoma Section of the American Institute of Professional Geologists has over 300 members, with the majority of these members working in or closely associated with the Oil & Gas Industry in Oklahoma.

The purpose of submitting these comments is to express our great concern as to the adverse effects of the Treasury Department's proposed changes in oil and gas taxation on the domestic Oil & Gas Industry, as well as in Oklahoma. Although these announced changes are only proposals, they have already had a noticeable impact on the domestic Oil & Gas Industry. This adverse impact is evident in reduced drilling activity by many of the independent oil and gas companies because of the possible loss of present tax incentives in the intangible drilling cost and percentage depletion. Rather than continue at their normal level of drilling, many of the independents have elected to significantly reduce their drilling commitments until they can determine the impact of the final rules and regulations on whether or not a profitable situation can be realized by drilling for oil and gas.

We believe these proposed changes in oil and gas taxation will have a direct and adverse impact on the majority of the AIPG Members in the following ways:

1. Declining drilling activity will reduce the need in companies for exploration and development personnel causing the loss of jobs for professional scientists who are trained to search for oil and gas.
2. The loss of tax incentives will discourage investments in oil and gas ventures by companies and individuals who participate in this risk-reward business and use the services of consulting Professional Geologists for evaluations and recommendations. This will result in significantly reducing the opportunity for these consultants to provide their services from which they derive much of their income and on which they pay taxes.
3. The proposed changes in the tax laws and regulations, particularly the loss of percentage depletion, will significantly reduce the funds available to AIPG Members with oil and gas production. These funds are normally re-invested in exploration and development to replace produced reserves or add to the reserve base.

Although the adverse impact of the proposed taxation on AIPG Members is of concern, the Institute's greater concerns are the effect of this change on taxation in general and the continuing ability of this vital domestic Oil & Gas Industry to reduce our Nation's dependence on foreign imports of petroleum. This is a strategic matter which affects our National Security and must be considered by the Committee in its evaluation of these proposed changes.

The American Institute of Professional Geologists urges the Committee to consider all of the above points in its evaluation of these proposed changes and to work toward a plan which will allow the domestic Oil & Gas Industry to continue to fulfill its essential role of providing energy sources through the timely and proper development of the country's natural resources in our Nation's free economy.

Thank you, Mr. Chairman, for providing the American Institute of Professional Geologists and its Oklahoma Section this opportunity to express our views.

CLAREMONT
CORPORATION

Official Committee File
SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES

February 15, 1985

Mr. David Doane
Senior Counsel
United States Senate Energy and Natural Resources Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Doane:

The following comments relate to the Treasury Department plan to revamp the federal income tax system regarding the domestic petroleum industry.

1. The impact upon small independent producers that depend on individuals for risk money, will be severe.
2. Once absorbed, the price of domestic oil will necessarily increase or fewer reserves will be found which will cause a greater dependence on foreign oil.
3. Natural gas prices will increase accordingly because most natural gas is domestic.
4. Percentage depletion is figured in the cost of finding oil and if lost would either raise the price or lower the reserves.
5. If enacted quickly, there would be considerable disruption in the industry and many financial problems.

I am an independent producer and will not have trouble surviving no matter what is enacted, but I will reduce expenditures and risk accordingly.

The government should give considerable thought to the idea before any dramatic changes are made. It created thy type of industry we have by its edicts and therefor needs to be responsible for them.

Very truly yours,

CLAREMONT CORPORATION

Frank W. Podpechan
President

FWP:je

Petroleum Exploration and Production
1303 Philtower Building / Tulsa, Oklahoma 74103 / (918) 582-5015

February 13, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy & Natural Resources Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Doane:

Having been advised by Senator Don Nickles of the opportunity to submit written comments on the Treasury Department's preliminary plan to revise the Federal Income Tax System, I offer the following in support of retaining the expensing of intangible drilling costs (IDC's).

The energy industry has been rocked by surpluses of both oil and gas and attendant precipitous declines in the prices of these products. This has created a shortage of drilling funds available to many companies. The removal of risk offsetting expensing of IDC's will virtually eliminate outside investment. The Interstate Oil Compact Commission study of this action indicates substantial drilling activity curtailment and ultimate loss of 90,000 jobs. Not only will state and federal tax revenue suffer from the loss of drilling activity and production income, they will also lose the taxes on wages associated with 90,000 jobs. The lost production will further increase our dependence on foreign supplies.

Rather than punitive removal of current tax incentives, additional incentives to encourage investors would increase the tax base at a time when that expansion is needed. Additional drilling would decrease dependence on volatile foreign supplies. A tax on imported crude would provide current federal revenue, while shoring up sagging product prices which threaten not only oil companies but also the U.S. banking system.

While a substantial first year or so increase in revenue would result from elimination of IDC expensing, it will be at a catastrophic long term cost.

Sincerely,

a. R. Reed
A. R. Reed

ARR:ph

Official Committee File

JAMES H. SHERRILL
GEOLOGIST - GEOPHYSICIST

TELEPHONE
918-583-5882 OFFICE
918-747-6944 HOME

933 MAYO BUILDING
420 SOUTH MAIN STREET
TULSA, OKLAHOMA 74103

February 5, 1985

President Ronald Reagan
The White House
Washington, D.C. 20501

Dear Mr. President:

I respectfully urge your strong opposition to the Treasury Department tax proposal regarding oil and natural gas. This bill would decimate the ranks of the independent producer in this country.

It is commonly known that independents drill the vast majority of wells in this country. Independent producers are dependent on outside capital for drilling funds. Elimination of the depletion allowance and expensing of intangible drilling costs will halt the flow of outside capital into the industry and slash domestic drilling. I do not believe that a reduction in domestic drilling is in the national interest. Thousands of independents will go bankrupt. The increase in unemployment and the effect on local and producer state economies will be devastating.

Most independent producers are very small -- like myself. My partner and I employ only five people. I can assure you if this tax bill passes that I will be out of business within six months and there will be five more people on the unemployment roster.

Mr. President, I have always been a staunch supporter of you and the Republican party. I feel this bill is in direct opposition to the economic policy that you and the party support. Passage of this bill would make this country again dependent on foreign oil and weaken national security.

I urge your opposition.

Respectfully submitted,

James H. Sherrill

James H. Sherrill

/psj

cc: Vice President George Bush
The Honorable Don Hodel
Mr. Robert C. McFarlane
Senator David L. Boren
Mr. David Doane

cc: The Honorable Donald Regan
Senator Don Nickles
Mr. Randall E. Davis
Congressman James R. Jones

Mr, David Doane

Dear Sir.

I can't see what can be gained about this tax they are trying to do to the oil industry.

oh yes I hear all the time about big oil co. can stand to have all this added. but I wonder if they don't know that it is all ways put on the little Guy. you look at them and see how many have just shut them down from drilling. trying to cut the little man out. look how many jobs were lost when the other was done. Magor companys are going to put us out of busness if you don't back the indendent oil Co.

just like the bailing out of the Chroysler Mo. co. and let the Farmers and endendent oil co. go to hoot.

2.

no wonder people are starving over seas and here. the Farmer cant do their part, and the oil wells have been shut down. so people has lost their jobs.

Mr & Mrs James F. Smith
P.O. Box 225
Ada, Okla.
74820

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
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WASHINGTON, D.C. 20510

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404 North 9th Street
Okemah, Oklahoma 74859
February 28, 1985

Mr. David Doane, Senior Counsel
United States Senate Energy & Natural Resources Committee
United States Senate
Washington, D. C. 20510

Dear Nr, Doane:

I receive the Newsletters from Senator Don Nickles and appreciate these so much and all that he is trying to do for our State of Oklahoma. He gave me an invitation to attend a meeting in Oklahoma City on the 15th of February where there would be a hearing on the impact of the Treasury Department's proposed changes in oil and gas taxation. I was unable to attend this meeting and he had stated that if there are any written comments we would like to submit for the record to send them to you.

For 27 years I worked in the oil and gas production business In Oklahoma and our State has always relied on this production for one of our principle industries.

I appreciate so very much all that Senator Don Nickles is doing, and also all that you are doing to try to help the oil production in Oklahoma and to help our general economy.

The Treasury Department's plan last November to revamp the federal income tax system, which was designed to lower the tax rates, and with provisions which required the capitalization of intangible drilling costs and the replacement of percentage depletion with a form of cost depletion, would seriously harm domestic oil production as well as impair the general economy.

Thank you for your help in this area. I am very interested in the Oil and Gas Industry in Oklahoma.

Sincerely,

Dud Smith

DS:lc

Official Committee File

HENRY WACKER
Box 966
GUYMON, OKLAHOMA 73942
(405) 338-6333

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES

February 13, 1985

Mr. David Doane, Senior Counsel
U. S. Senate Energy & Natural Resources Committee
U. S. Senate
Washington, D.C. 20510

Dear Mr. Doane:

we are semi-retired farmer and small-time oil and gas invester.

If the proposed changes in the tax law concerning charging off IDC and percentage depletion, we will be out of the investment business.

Our file cabinet is full of dry hole files, but with the tax advantage of the IDC chargeoff and percentage depletion, we can still afford the investments if we get a well occasionally.

This will no longer be true if these two items are knocked down. The impact on our energy industry would be devastating.

We would then certainly be at the mercy of the Arab nations in the future--and not too distant future.

Very truly yours

Henry Wacker

Henry Wacker

Laverne, Oklahoma 73848
Box 687
February 23, 1985

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
FEB 27 [illegible]
WASHINGTON, D.C. 20510

Mr. David Doane
Senior Counsel
United States Senate Energy
and Natural Resources Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Doane:

I wish to register my opposition to the proposed tax simplification of the Treasury Department as it affects the oil industry. Oklahoma's economy depends to a very great extent on the oil industry. If the 15% depletion allowance and the deduction given the companies for dry holes are abolished Oklahoma's oil industry will decline disastrously. The depletion allowance has already been decreased in the last few years. There is already a windfall tax plus a severance tax to the state. Any more taxes placed on the oil industry will have decidedly negative effect to the point of severely declined production. Companies will not drill nor produce if they are taxed to the point at which they cannot afford to operate. Most of the wells drilled and produced are initially at least done by small companies and NOT by large corporations.

I wish to emphasize the point that further taxation of this industry will affect production and Oklahoma's economy in a very negative way. When the United States' oil companies stop or drastically curtail production than we will have to depend on the OPEC countries for our supply; then where will the tax come from? I am a retired farmer - retired because I am unable to work any longer - and I have a comparatively small mineral interest which helps me to survive.

Sincerely,
Robert L. Ward
Robert L. Ward

RLW/bw

Official Committee File

WILSON ENERGY

CAMPBELL CENTRE, SUITE M-2150 • DALLAS, TEXAS 75206 • (214)361-8920

February 12, 1985

Jim Wilson
Partner

Mr. David Doane, Senior Counsel
United States Senate
Energy and Natural Resources Committee
Washington, D. C. 20510

Dear Mr. Doane:

I would like my opposition to be recorded regarding the Treasury Department plan requiring the capitalization of intangible drilling costs and the replacement of percentage depletion with a form of cost depletion. Such change would seriously damage domestic oil production and ultimately make the United States more dependent upon imported oil. In addition, many jobs would be lost and businesses would fail.

I have been an active supporter of President Reagan for many years, and his endorsement of such legislation would go against everything he has stood for regarding this important industry.

Sincerely,

James M. Wil

James M. Wilson

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FEB 19
WASHINGTON, D.C. 20510